State of Washington

Plan II Retirement Age Report

As Authorized by the
Joint Committee on Pension Policy
Washington State Legislature

October 1992

Washington State Legislature

Joint Committee on Pension Policy

Senator Irv Newhouse, Chair
Representative Helen Sommers, Vice Chair

Senators

Al Bauer
Jeannette Hayner
Ray Moore
Gary Nelson
Janice Niemi
A.L. "Slim" Rasmussen
Gerald Saling

Representatives

Jennifer Belcher
Lorraine Hine
Alex McLean
Richard Neher
Duane Sommers
Harriet Spanel
John Wynne

State of Washington

Plan II Retirement Age Report

As Authorized by the
Joint Committee on Pension Policy
Washington State Legislature

October 1992

Prepared by:

Office of the State Actuary
2420 Bristol Court SW Suite 101
Olympia, WA 98504-0914
(206) 753-9144

ACKNOWLEDGEMENT

Work on the Retirement Age Study officially began in October 1990. Since that time, each member of the State Actuary's staff has contributed toward its completion and this final report. For their dedication and competent efforts, I am most grateful to my staff.

In particular, there are three individuals whose involvement in this project demands specific recognition: My special thanks go to Toni Bentley, Pete Cutler, and Dr. Robert Hollister.

> From the first draft to the final edit, no person was more intrinsically a part of this project than our Word Processing Specialist, Toni Bentley. Through countless revisions and re-revisions, she maintained remarkable composure.
>
> Collecting this study's many and disparate findings into a final report was a gargantuan task. It was Pete Cutler's responsibility to pull it all together and "highlight" the most important points. While no longer with this office, we wish to recognize his essential contribution to this report.
>
> I am also indebted to Dr. Robert Hollister for volunteering his time and expertise in the development of this report. His experience as Director of the Department of Retirement Systems from 1977 through 1988 and his long-standing interest in public retirement policy were invaluable to this endeavor.

Lastly, I am grateful for all the comments from public employers, labor and taxpayer organizations, employee groups and others. Their participation helped make this project a true examination of policy issues.

GERALD B. ALLARD
State Actuary

TABLE OF CONTENTS

LIST OF APPENDICES

Executive Summary of the Retirement Age Report

Chapter 1 - Introduction

Major changes in retirement plan design for LEOFF, TRS and PERS were adopted in 1977. There appears to be major employee dissatisfaction with some of the provisions of these plans, specifically with the retirement eligibility criteria.

In October 1990 the Joint Committee on Pension Policy directed staff to do a study of the Plan II retirement ages and related issues.

Chapter 2 - Overview

Role of Retirement Eligibility in Plan Design:

Retirement eligibility is fundamental to the design of a pension plan and should be coordinated with other benefits, personnel polices, and the philosophy behind the entire benefit package. It determines workforce/retiree demographics.

Plans with *low* retirement ages result in a younger workforce and a retiree group that has a broader range of ages. It is extremely costly to try to maintain retirees' pre-retirement standard of living over 30 or more years.

Plans with *high* retirement ages result in an older workforce and a retiree group with a narrower range of ages. It is less costly to maintain a pre-retirement standard of living because Social Security and Medicare help augment benefits and a fixed COLA is more likely to be adequate.

Retirement eligibility is also closely related to the issue of how pension plan resources are allocated between those members who retire from the system versus those who leave prior to retirement. If the plan design provides value solely to those who stay until retirement, then there will be pressure to allow earlier retirement as the only way to get value.

Figure 1 illustrates the significant differences among the three Plan I systems as to the distribution of ages at retirement:

Figure 1

Service and Disability Retirements
Age At Retirement

	LEOFF I	TRS I	PERS I
Age < 50	45%	1%	2%
Age 50 - 54	38%	14%	6%
Age 55 - 59	11%	36%	13%
Age 60 - 64	4%	41%	59%
Age 65 & Over	2%	8%	20%

Figures 2 and 3 demonstrate the difference Plan II retirement ages will make in the number of years the average retiree works versus the average number of years in retirement.

Figure 2

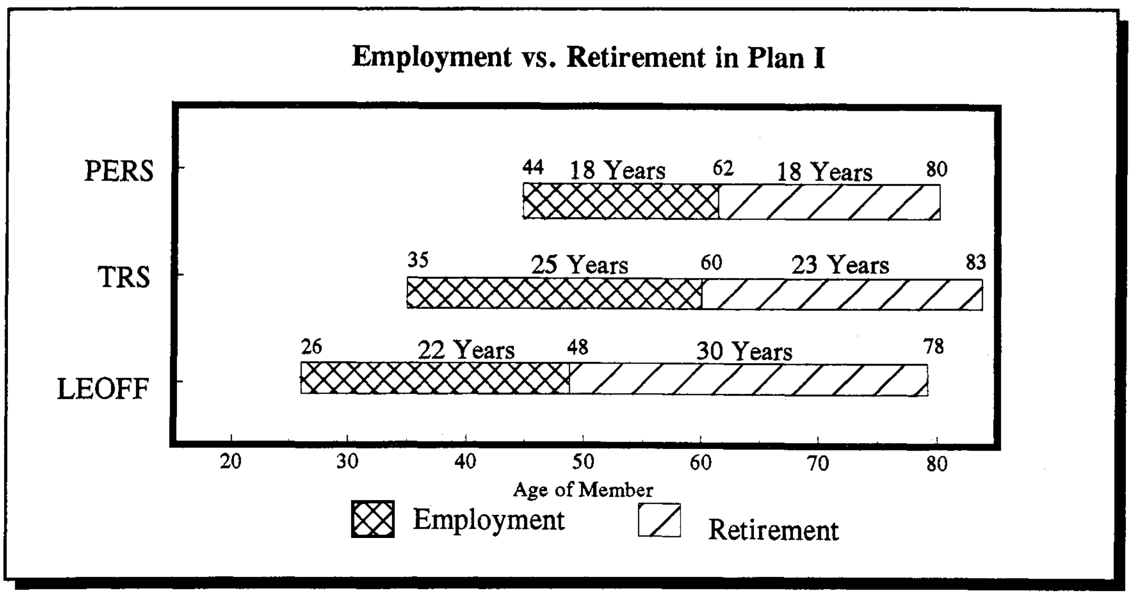
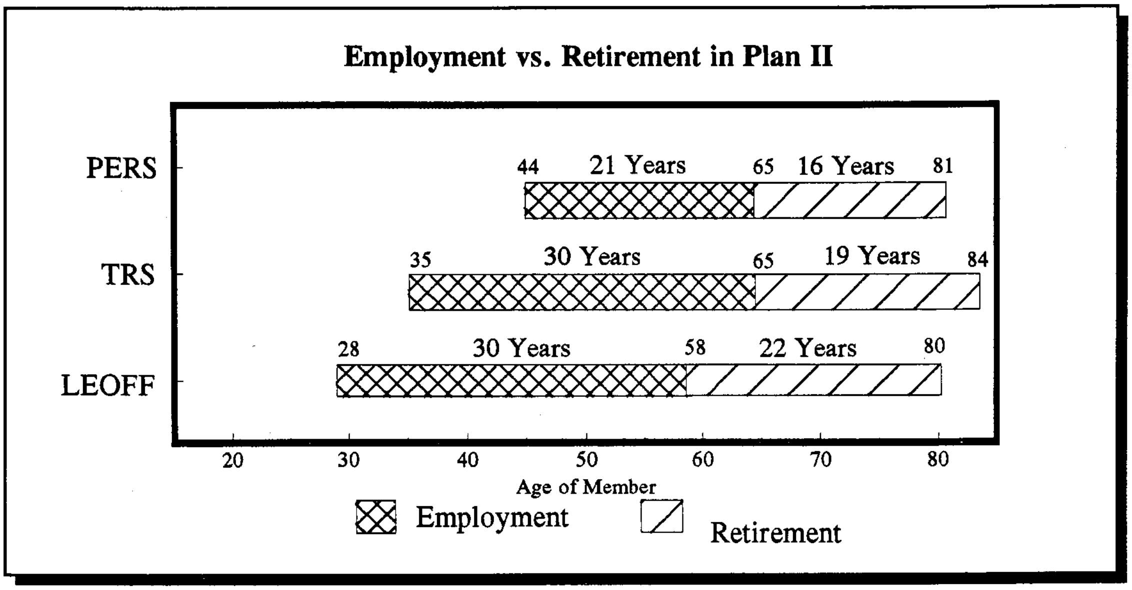


Figure 3



Creation of Plan II Systems:

The Plan I systems have "career-based" retirement eligibility and provide retirement benefits at ages prior to when members are expected to permanently leave the workforce.

The Plan II systems were created in 1977 in response to three major problems:

- High cost and abuses of disability retirements in LEOFF I;
- Increasing pressure for COLAs in TRS and PERS; and
- Increasing costs of the Plan I systems.

Due to legal constraints created by the courts, the Legislature then, as now, could not reduce benefits for current employees. The Legislature's lack of flexibility to take corrective action in response to the problems of the Plan I systems required that new systems be developed and that they be designed in such a way as to minimize future risks.

Figure 4 reflects the cost savings resulting from the Plan II systems.

Figure 4

Estimated Savings Due to Creation of Plans II

	PERS	TRS	LEOFF	TOTAL
State & K-12				
1993-95 Biennium	$74 Million	$72 Million	$244 Million	$390 Million
25 Years	$2.8 Billion	$3.4 Billion	$9.7 Billion	$15.9 Billion

The adoption of Plans II set forth the following implicit policies:

- Retirement benefits are only paid at an age when employees are generally presumed to permanently leave the workforce.
- The Plans provide an adequate initial benefit at retirement for a long-service member.
- The benefit will be annually adjusted to assist in retaining the original purchasing power of the benefit.
- All public employees receive identical, or at least very similar, benefits to reduce "leapfrogging" pressures.
- The contribution rate is shared equally by the employer and employee, as a way to reduce constant pressure for benefit enhancements.
- The retiree's benefit is secure - not dependent on the economy or financial markets, nor on the judgement of the retiree.
- To ensure the benefit is used for retirement, the member is given few options in how it is received.
- Disability and death benefits are insurance concerns and not part of a retirement system.

Chapter 3 - Employee Concerns

Most members of the Plan II systems are not satisfied with their retirement plans.

Figure 5

In general, do you consider yourself satisfied or dissatisfied with your retirement benefits?

	PERS II	TRS II
Satisfied	12%	2%
Dissatisfied	52%	75%
Not Sure	36%	23%

LEOFF II members were not asked this question.

The most basic concerns appear to be:

- Employee organizations believe their members should be able to collect a pension after completing a certain number of years of service ("career-based" retirement) rather than after permanently leaving the workforce ("age-based" retirement).
- Employees who leave prior to retirement don't feel they receive "reasonable value" from the retirement system.
- The interest credited to member accounts has been less than market rates and the trust fund earnings; and
- Members have almost no flexibility in the form and/or timing of their benefits.

As shown below, it is estimated that only 20 percent of the PERS members who enter at age 25 will stay for 30 years.

	PERS	TRS	LEOFF
Entry Age 25 -- Probability of Staying 30 Years	20%	50%	70%

It is expected that those Plan II members who do stay will be content with their benefits after retirement.

Chapter 4 - Employer Concerns

- Few employers are familiar with the Plan II benefit provisions.
- Plan II employers have given little thought to the impact of Plan II systems on their operations and/or salary plans.
- They do not want higher costs.
- They do not believe retirement benefits have an impact on recruitment.
- Burnout and job stress are not retirement issues, but rather are personnel issues not related to length of service or age.
- It would be helpful to have some kind of benefit to assist employees in making career transitions prior to retirement.

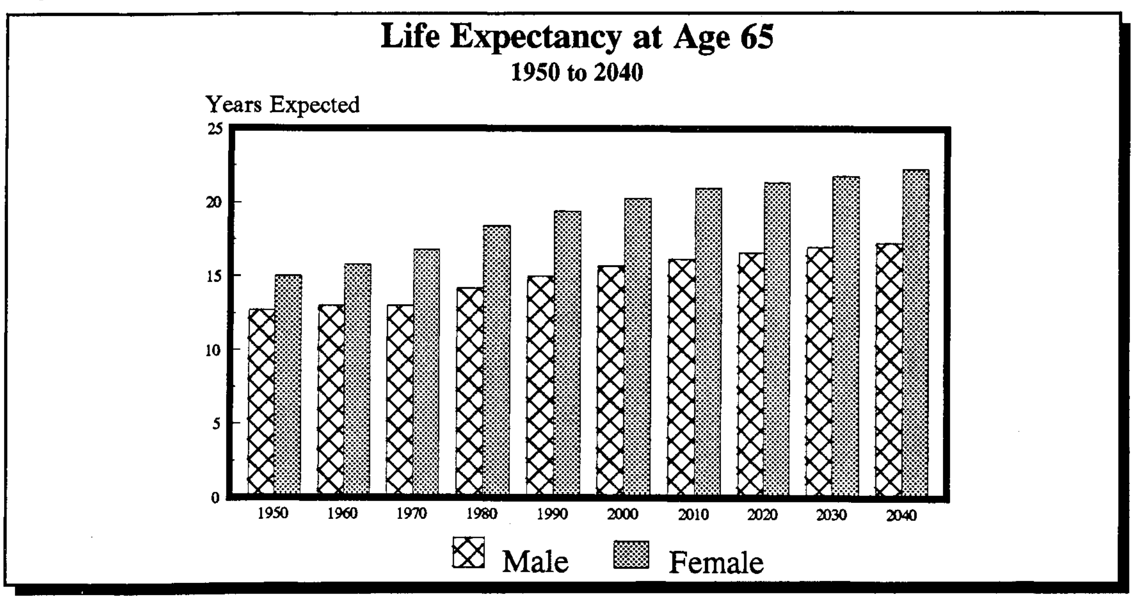
Chapter 5 - Federal, State, and Private Sector Systems

Social Security:

Federal retirement and tax policies have increasingly taken the approach of encouraging workers to delay retirement.

Figure 6 shows actual and projected increases in life expectancy through the year 2040.

Figure 6



The normal retirement age for Social Security was raised from age 65 to age 67. The early retirement age is still 62, but the early retirement reduction will increase from 20% to 30%.

Figure 7

Social Security Normal Retirement Age
Current Plan II Members

	PERS	TRS	LEOFF
Age 67	14%	23%	23%
Between 65-67	72%	71%	74%
65	14%	6%	3%

The Social Security program expects most persons will still retire near age 62. Therefore the practical impact is expected to be a reduction in the level of benefits paid to retirees, not a delay in the departure from the workforce.

Federal Employees' Retirement System:

In 1986 a new Federal Employees Retirement System (FERS) was created which consists of a combination of three benefits: (1) Social Security; (2) a basic pension plan; and (3) a defined contribution thrift plan.

Figure 8

FERS Basic Benefit Plan Provisions

Pension Formula:	1% x Average Final Pay x Service; or 1.1% for Retirement at Age 62 with at Least 20 Years.
COLA:	Generally change in CPI minus 1%, after Age 62.
Employee Contribution:	.8%

Figure 9

FERS Thrift Plan Provisions

	Employee	Federal Government
Automatic:	0	1% of Pay
Optional:	First 3% of Pay	Match $1 for $1
	Next 2% of Pay	Match $.50 for $1
	Next 5% of Pay	0
Maximum:	10% of Pay	5% of Pay
Investment Options:	Government Securities Funds; Fixed Income Fund; and Common Stock Index Fund.	

The main goals of the new plan design were to provide greater flexibility, to increase the value received by employees who leave prior to retirement, and to reduce costs.

Three changes in the new plan design promote delayed retirement:

- A small increase in the normal retirement age for the basic benefit pension;
- Inclusion of federal employees in Social Security; and
- Use of the defined contribution thrift plan.

Other States Comparisons:

The Plan II retirement ages are higher than those in most other state retirement systems:

- The most common retirement eligibility provisions for general public employees (PERS) and teachers (TRS) is age 60 with 5 to 10 years of service, with earlier eligibility for long-service employees.
- The most common eligibility provisions for police and fire employees are age 50 or 55 with 20 years of service, or just 20 years of service.

Most state retirement systems for general public employees (PERS) and teachers (TRS) use a combination of age and service (e.g., age 55 with 25 years of service) or service only (e.g., 30 years and out) to establish eligibility for retirement. Very few base eligibility solely on age.

Many state retirement systems subsidize early retirement by applying early retirement reduction factors that are less than the full actuarial equivalent, as shown in the following chart:

Figure 10

	Number of Funds
Discount rates less than 3%	1
Discount rates of 3% to 5.9%	22
Discount rates of 6% or more	22
Discount rates vary according to service or age	16
Employs actuarial discount table	12
Formula multiplier varies by age	4
Money purchase plan	1
No early retirement provided	7

A number of states have departed from the traditional public sector retirement system design. For example: California, Hawaii, Vermont and Maryland have recently adopted new non-contributory "basic" defined benefit plans, with higher normal retirement ages. Utah has a new non-contributory defined benefit plan and a defined contribution plan which is optional for local governments. West Virginia recently adopted a new defined contribution plan for teachers.

Other States - Trends:

Public sector systems show a schizophrenic approach to retirement age policy. Many states have recently reduced the age and/or service requirements for normal retirement, but several others have raised theirs. Some, such as Washington State, have adopted higher retirement ages for all newly hired employees, while also making further reductions in the already lower retirement ages applicable to current employees.

Private Sector Systems Comparisons:

Most small private sector employers either do not cover their employees in any retirement system, or only in defined contribution plans.

Most large private sector employers provide retirement plans which have two elements: (1) a non-contributory defined benefit plan; and (2) a defined contribution plan.

The PERS II and TRS II normal retirement ages are somewhat higher than those in most very large private companies:

- Most of the very largest company plans permit unreduced retirement for salaried employees at age 60 or 62.
- Most very large company plans also use early retirement reduction factors which partially subsidize early retirement, as shown in the following chart:

Figure 11

	Number of Funds
Discount rates less than 3%	4
Discount rates of 3% to 5.9%	27
Discount rates of 6% or more	8
Actuarial discount table	3

Private Sector Systems - Trends:

The use of "401(k)" or "thrift/savings" defined contribution plans has grown rapidly in recent years. *Such plans frequently provide for matching employer contributions and are very popular with active employees.*

Chapter 6 - Employee Concerns - Analysis

"Career Retirement":

The issue of what benefit should be provided to those who leave covered employment earlier than when they leave the workforce is central to the retirement age question.

Many public safety employees and teachers believe they deserve a lifelong pension after providing a certain number of years of service or if they reach a point where physical limitations or stress prevent them from continuing in their chosen career.

"Career-based" retirement plans, i.e., plans which permit retirement at young ages after completion of a number of years of service, are very expensive:

- Benefits are more likely to lose significant purchasing power (even with a 3% COLA) leading to pressure for additional COLAs; and

- Post-retirement medical benefits must be paid (by the retiree or employer) for a longer period before the retiree qualifies for Medicare.

LEOFF I is an example of the benefits that would be provided under a complete "career-based" retirement plan.

Academic research indicates there is no objective data which points to a "magic age" at which persons uniformly or predictably become unable to carry out the duties of any given occupation. Recent studies have concluded:

- Chronological age is a poor indication of ability to perform a job; and

- Abilities associated with job performance do not inevitably decline with age. As workers age, there is greater variation in their abilities and, in some cases, there is an improvement of certain skills and abilities.

As shown below, 62 percent of Plan I teachers reported that stress would likely be a very important factor in their decision to retiree. However, there is no evidence that stress was related to age or length of service, or any other factor connected to retirement eligibility.

Figure 12

Active members
Anticipated Importance of Stress in Decision to Retire

	PERS I	TRS I
Very Important	25%	62%
Somewhat Important	54%	32%
Not Important	21%	6%

Career Transitions versus "Golden Handcuffs":

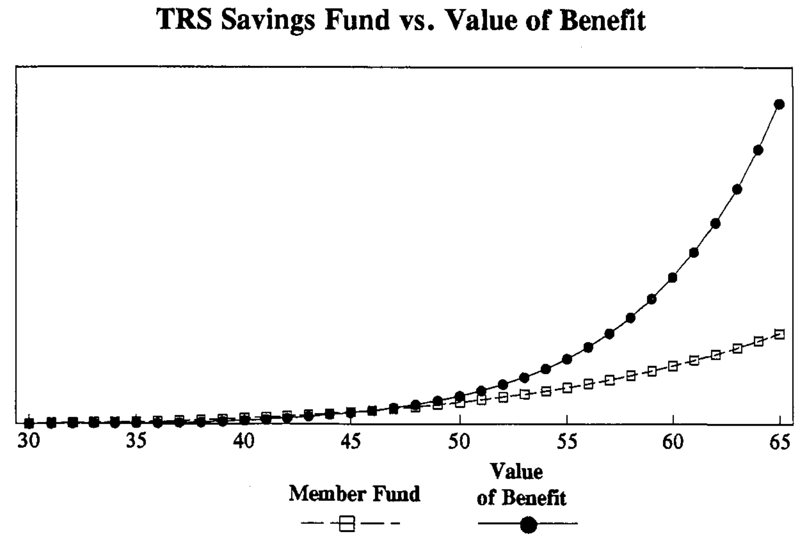
The Plan II systems have a "golden handcuffs" design:

- They provide very little value for employees who leave service prior to retirement; and

- They provide very great value to employees who stay until retirement.

The most commonly sought way for members with significant service to obtain "value" from their retirement plan is to get the retirement age lowered so they can receive an immediate benefit on termination.

Figure 13



The Plan II benefit design discourages members from changing careers to new jobs covered by other retirement systems, unless the systems are included in the portability statute:

- The benefit at age 65 or 58 may have only a small fraction of the purchasing power it had at the time of the career change; and
- The financial incentive to stay increases as the members get closer to being eligible for retirement.

The "golden handcuff" design also has an impact on employers in that it tends to retain unsatisfactory employees as much as, or more than, productive employees.

Portability:

Benefits are "portable" if a member can maintain the value of retirement benefits earned for past employment when changing jobs prior to retirement.

There are several ways to make benefits "portable." Some examples include:

- Use of defined contribution plans (TIAA/CREF);
- Reliance on Social Security;
- Indexing vested, out-of-service benefits; and
- Moving service credit or final salary between defined benefit systems.

Chapter 7 - Employer Concerns - Analysis

Employers do not want higher pension costs. Increased pension costs force an unwelcome choice between reducing other programs or raising taxes.

Employers who have salary plans that provide increases based on seniority and strong tenure provisions have a strong incentive to support early retirement proposals in times of budget shortfalls.

Employers generally favor an environment which would be supportive to those employees who wish to make career transitions prior to retirement.

Chapter 8 - Disability Issues

LEOFF II members are dissatisfied with their duty-disability benefits.

There are many ways to define "disability":

- "Total disability" refers to the inability to engage in *any* employment or occupation. It is a stringent standard, used by Social Security.

- "Occupational disability" refers to the inability to engage in an employee's *current* occupation. It has been applied very broadly in LEOFF I to include stressful conditions associated with a specific employer.

The normal retirement age for service retirement is not as important an issue for employees who can easily qualify for an "occupational disability."

Having a high retirement age while keeping an occupational disability standard would not significantly increase the age at which people retire.

Further, lowering the normal retirement age does nothing for the individual who becomes occupationally disabled at 30-40. One of two things will occur: (1) pressure to lower the normal retirement age further; or (2) pressure to adopt a liberal disability program which will render normal retirement age meaningless as it essentially is in LEOFF I.

It is often impossible to objectively tell whether a specific condition such as stress, back injuries, etc. should qualify as a "total disability," an "occupational disability" or not a disability at all.

Some of the factors which motivate employees to leave a job prior to retirement from the workforce are shown below. These range from those which are entirely voluntary to those which are entirely involuntary.

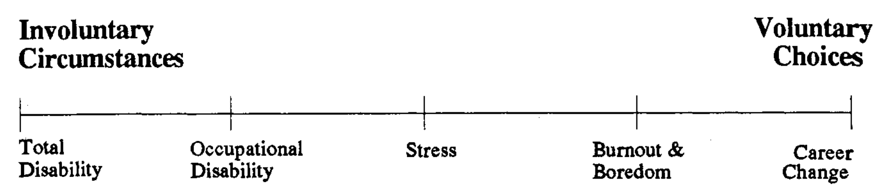
It is often difficult to determine whether or not a disability condition was caused by employment, i.e., whether it is a "duty" disability.

Disability insurance that pays the same benefit a member would have been expected to earn if the career had continued to retirement provides "career protection." LEOFF I has such a design.

Disability insurance that pays benefits only where there has been a reduction in earnings and/or earning power provides "earning power protection." Industrial insurance has such a design.

Figure 14

Factors which Motivate Employees to Leave a Job Prior to Retirement from the Workforce



Chapter 9 - Social Contract versus Deferred Compensation Policies

Social Contract:

Under the Social Contract approach to plan design, an employee who provides a long period of service and reaches a prescribed age is entitled to a lifelong benefit sufficient to maintain the pre-retirement standard of living. This policy approach is usually popular with *retirees*.

To ensure the goals of the "Social Contract" are achieved, there can be little flexibility in how benefits are paid.

The Plan II systems reflect the "Social Contract" approach to pension policy.

Deferred Compensation:

Under the Deferred Compensation approach to plan design, some of the compensation earned by an active employee is not paid when earned. These amounts are set aside, invested and paid at a later time. This policy approach is usually popular with *active employees*.

Under this policy approach, employees can be provided with considerable flexibility as to the time and form of payment because the employers' only commitment is to pay the amounts which have been set aside.

Such a plan by implication offers no assurance as to the standard of living that will be enjoyed in retirement.

One type of design implementing this policy approach would be a defined contribution plan.

For a given level of funding, more can be done to reduce the dissatisfaction of *active employees* through a defined contribution plan which provides flexible contribution and payout options than through a defined benefit plan which has a paternalistic design.

Chapter 10 - Evaluation Criteria

The criteria for evaluating possible approaches to modifying the Plan II systems reflect *employee concerns, employer concerns* and the *current Plan II policies.*

No approach can satisfy all three sets of criteria at the same time.

Chapter 11 - Possible Approaches for Change

Five of the many possible approaches to modify the Plan II systems to respond to employee and employer concerns are presented.

The first three approaches would generally continue the benefit design of the current Plan II systems:

Approach 1: (a) Lower the normal retirement ages for the Plan II systems to Plan I retirement ages; or (b) Significantly reduce the early retirement reduction factor for calculating early retirement benefits.

Approach 2: Maintain current Plan II benefit design with changes to increase career mobility, and to allow limited payments prior to retirement.

- Optional job/retirement transition benefit
- Automatic increase for vested benefits
- Expanded coverage of portability statute
- Market rate interest on member contributions
- Withdrawal of contributions at retirement

Approach 3: Allow employees to choose between three different retirement plans, each with benefits similar to current Plan II systems, except for different normal retirement ages.

Two of the approaches would involve replacement of the current Plan II systems:

Approach 4: Replace current Plan II systems/benefits with new "split plans" which reflect typical private sector and new Federal Employees Retirement System plan design.

- Employer funded basic defined benefit plan
- Employee and employer funded defined contribution plan

Approach 5: Replace Plan II systems with defined contribution plans.

Chapter 12 - Approach 1(A)

Lower the Normal Retirement Ages for the Plan II Systems to Plan I Retirement Ages.

Description:

Reduce the Plan II normal retirement ages to the current Plan I provisions:

LEOFF II	Age 50 with 5 years of service
PERS II/TRS II	Age 60 with 5 years; age 55 with 25 years; or any age with 30 years of service

Advantages:

(1) Responds to employee organizations' desire for service or career based retirement.
(2) Responds to employees' desire for longer period of retirement.
(3) Provisions would be as generous, or more generous, than most other state retirement systems, and most local LEOFF systems.

Disadvantages:

(1) Does not provide reasonable value for employees who change jobs prior to normal retirement due to career change or occupational disability.
(2) Does not provide significant additional flexibility.
(3) High cost.
(4) Additional pressure for COLAs and post-retirement medical benefits.

Cost:

Figure 15

Early Retirement Proposals - Plan I Retirement Age

(In Millions)	PERS	TRS	LEOFF	TOTAL
State & K-12 Biennial Cost 1993-95	$143	$91	$9	$242
Increase in State Rate	2.84%	3.84%	1.10%	
Local Government Cost 1993-95*	$72	---	$13	$85
Increase in Local Employer Rate	2.84%	---	1.65%	
Average Increase in Annual Member Cost 1993 (dollars)	$825	$1,305	$1,181	
Increase in Member Rate	2.84%	3.84%	2.75%	

* If the State's share of the increased cost in LEOFF II were paid by the local employers, their total rate increase would be 2.75% and the total cost increase would be $22 million for 1993-95.

Chapter 13 - Approach 1(B)

Significantly Reduce the Reduction Factors for Calculating Early Retirement Benefits.

Description:

Approach 1(B) would keep the current Plan II normal retirement ages, but lower the early retirement adjustment factors from a full actuarial adjustment (about 7 -9 % per year) to 1% per year.

The eligibility criteria for early retirement would remain the same - age 55 with 20 years service in PERS II and TRS II, and age 50 with 20 years service in LEOFF II.

Advantages:

(1) Provides greater value for employees who leave employment prior to normal retirement age if they leave after earning 20 years of service and reaching age 55 (PERS II and TRS II) or age 50 (LEOFF II).

(2) The reduction factor for early retirement would not appear to be punitive.

Disadvantages:

(1) Does not provide value for employees who leave employment prior to becoming eligible for early retirement.
(2) High cost.
(3) Would lead to additional pressure for COLAs and post-retirement medical insurance.

Costs:

Figure 16

Subsidize Early Retirement Factors
1% for 10 years (8 LEOFF)

(In Millions)

	PERS	TRS	LEOFF	TOTAL
State & K-12 Biennial Cost 1993-95	$101	$66	$6	$173
Increase in State Rate	2.01%	2.78%	.74%	
Local Government Cost 1993-95*	$51	---	$9	$60
Increase in Local Employer Rate	2.01%	---	1.12%	
Average increase in Annual Member Cost 1993 (dollars)	$583	$945	$800	
Increase in Member Rate	2.01%	2.78%	1.86%	

* If the State's share of the increased cost in LEOFF II were paid by the local employers, their total rate increase would be 1.86% and the total cost increase would be $15 million for 1993-95.

Figure 17

Impact of 1% Early Reduction Factor (ERF)

LEOFF II at age 50:	TRS II at age 55:
Age 58 - 50 = 8 yrs = 8% reduction	Age 65 - 55 = 10 yrs = 10% reduction
\$40,000 x 25 years x 2% = \$20,000	\$40,000 x 30 years x 2% = \$24,000
x .92	x .90
Annual Benefit = \$18,400	Annual Benefit = \$21,600

Impact of Current ERF

LEOFF II at age 50:	TRS II at age 55:
Age 58 - 50 = 8 years = 55% reduction	Age 65 - 55 = 10 years = 63% reduction
\$40,000 x 25 years x 2% = \$20,000	\$40,000 x 30 years x 2% = \$24,000
x .45	x .37
Annual Benefit = \$9,000	Annual Benefit = \$8,880

Chapter 14 - Approach 2

Maintain Current Plan II Benefit Design, with Changes to Increase Career Mobility and to Allow Limited Payments Prior to Normal Retirement.

1) **Automatic Increase for Vested Benefits**

Description:

Upon separation from covered employment with 20 or more years of service, Plan II members who leave their contributions with the system (also known as terminated, vested members) would have their benefit increased each year during the period between termination and retirement. The annual increase would be based on the same formula as the Plan II COLA - the change in the Seattle CPI, up to 3% per year. The member would not begin receiving the benefit until the normal retirement age (58 or 65).

Advantages:

Would make it possible for long-service employees to change jobs to the private or public sector without destroying the value of their retirement benefits.

Disadvantages:

Cost.

Figure 18

Automatic Increase for Vested Benefits

(In Millions)

	PERS	TRS	LEOFF	TOTAL
State & K-12 Biennial Cost 1993-95	$1	$2	<$1	$3
Increase in State Rate	.03%	.07%	.02%	
Local Government Cost 1993-95*	$1	---	<$1	$1
Increase in Local Employer Rate	.03%	---	.02%	
Average Increase in Annual Member Cost 1993 (dollars)	$8	$23	$16	
Increase in Member Rate	.03%	.07%	.04%	

* If the State's share of the increased cost in LEOFF II were paid by the local employers, their total rate increase would be .04% and the total cost increase would be $1 million for 1993-95.

2) <u>Expand Coverage of Current Portability Statute</u>

Description:

The coverage of Chapter 41.54 RCW which creates a portability benefit for members of PERS I, PERS II, TRS I, TRS II, and the WSPRS would be amended to include LEOFF II, and the Seattle, Tacoma, and Spokane employee retirement systems.

Advantages:

Would make it possible for employees to change jobs to a wider range of public sector positions while maintaining value for their early years of service.

Disadvantages:

Cost.

Figure 19

Expanded Portability

(In Millions)

	PERS	TRS	LEOFF	TOTAL
State & K-12 Biennial Cost 1993-95	$1	<$1	<$1	$2
Increase in State Rate (Plan II)	.02%	.01%	.03%	
Local Government Cost 1993-95*	<$1	---	<$1	$1
Increase in Local Employer Rate	.02%	---	.04%	
Average Increase in Annual Member Cost 1993 (dollars)	$6	$3	$30	
Increase in Member Rate (Plan II)	.02%	.01%	.07%	

* If the State's share of the increased cost in LEOFF II were paid by the local employers, their total rate increase would be .07% and the total cost increase would be $1 million for 1993-95.

3) <u>Pay "Market Rate" Interest on Member Contributions</u>

Description:

Member contributions would be credited with interest at a rate which more closely reflects market rate interest. This could be accomplished by any of a variety of methods, such as by crediting accounts with the average return earned by medium- or long-term government bonds, or the five year average returns earned by the State Investment Board.

Advantages:

(1) Would increase the *perceived* value for the retirement systems for *active employees*.
(2) Responds to the most frequent active-member complaint.

Disadvantages:

Cost.

Figure 20

"Market Rate" Interest (Assume 7.5%)

(In Millions)

	PERS	TRS	LEOFF	TOTAL
State & K-12 Biennial Cost 1993-95	$3	$1	<$1	$4
Increase in State Rate	.06%	.04%	.01%	
Local Government Cost 1993-95*	$1.5	---	<$1	$2
Increase in Local Employer Rate	.06%	---	.01%	
Average Increase in Annual Member Cost 1993 (dollars)	$17	$14	$9	
Increase in Member Rate	.06%	.04%	.02%	

* If the State's share of the increased cost in LEOFF II were paid by the local employers, their total rate increase would be .02% and the total cost increase would be less than $1 million for 1993-95.

4) Optional Job/Retirement Transition Benefit

Description:

A new benefit option would permit Plan II members with 20 or more years of service to be paid a monthly income from their accumulated contributions under two circumstances:

- 50% of pay for up to two years while training for a new career or on a sabbatical break (job transition benefit); or
- up to 50% of pay, or the member's accrued benefit, when leaving the work force between age 60 and 65 (retirement transition benefit, PERS II and TRS II only).

The member would receive a reduced benefit at retirement to reflect the member contributions paid out before normal retirement age. The reduced benefit could be actuarially equivalent or could be partially subsidized.

Advantages:

Provides additional flexibility to employees in certain limited circumstances.

Disadvantages:

(1) Only provides flexibility in certain limited circumstances.
(2) Possible federal tax code limitations.
(3) Possible administrative complexity.

Cost:

As proposed, it would be assumed that those members who receive a job transition or retirement transition benefit would later receive an actuarially reduced allowance at normal retirement. This option would result in no additional cost to the state. If the state wished to partially subsidize the benefit, such as by not providing for a full actuarial reduction at retirement, there would be a cost. Local government could also be authorized to provide this benefit on a "self-pay" basis.

Figure 21

Example of "Job Transition" Benefit (Percentage Reduction in Initial Retirement Benefit at Age 65)

Age and Service at time of Sabbatical/ Job Transition	Sabbatical Leave (Return to Covered Service)	Career Change (No Return to Covered Service)
Age 50, 20 Years of Service	11% Reduction	32% Reduction (from terminated, vested benefit)

Assumptions: (1) Employee starting salary of $20,000, with average merit and general annual increases; (2) Employee collects 50% of salary for 12 months.

5) <u>Optional "Phased Retirement" Benefit</u>

Description:

A new benefit option would permit PERS II and TRS II members to work half-time and at the same time collect 50% of their accrued retirement allowance, for up to 3 years prior to full retirement. The members would have to be age 62 or older and would have to enter into a contract for the half-time service with his or her employer. At full retirement, the member's benefit would be calculated using a full-time salary, and partial credit for the period of part-time employment.

Advantages:

Provides additional flexibility to employees in certain limited circumstances.

Disadvantages:

Only provides flexibility in certain limited circumstances.

Cost:

The member who takes advantage of the phased retirement option and would receive a reduced benefit at normal retirement to adjust for payments made prior to the normal retirement age. If a full actuarial reduction were made, there would be no cost to the system.

6) <u>Withdrawal of Accumulated Contributions at Retirement</u>

Description:

Plan II members would be permitted to withdraw their contributions, plus interest, at retirement, as TRS I members are currently allowed to do. The retiree's retirement allowance would be actuarially reduced to reflect the value of the withdrawn contributions.

Advantages:

Withdrawal of contributions at retirement is very popular in TRS I.

Disadvantages:

Retirees may later regret long-term reduction in their monthly pension.

Cost:

Could be implemented on a cost neutral basis.

Chapter 15 - Approach 3

Allow Employees to Choose Between Three Different Retirement Plans, Each with Benefits Similar to Current Plan II Systems Except for Different Normal Retirement Ages.

Description:

Create three new retirement plans with benefit provisions similar to PERS II, except that each retirement plan would have a different normal retirement age: age 65 (Tier 3A), age 60 (Tier 3B), and age 55 (Tier 3C).

Employees would have the option of selecting which plan they wished to be covered under, but would pay higher contribution rates for service earned under the plans with the earlier retirement ages (Tiers 3B and 3C). Benefits would be portable, i.e., the salary earned while participating in one of the three plans could be used to calculate benefits in the other two plans. Employees would be given frequent chances to move between the different plans.

Advantages:

Provides employees with a choice of retirement ages; only those who value earlier retirement have to pay higher contribution rates.

Disadvantages:

(1) Does not provide value for employees who leave prior to retirement.
(2) Cost to the state would be dictated by employee choices: could be high cost if most employees choose the age 55 and 60 plans.
(3) Employees who choose the age 55 plan are likely to bring pressure for improved COLAs and post-retirement medical benefits.
(4) Does not provide flexibility for employees who select the age 65 plan, but at a later age decide they want or need to leave the workforce prior to age 65.

Cost:

Assuming the equal contribution-sharing policy of the Plan II systems is retained, this approach could require significant increases in employer contribution rates, depending on which employees and how many employees selected the age 55 and 60 plans. Substantial additional analysis would be necessary to develop a reliable cost estimate.

If employee contribution rates were increased to pay 100% of the additional cost associated with the lower retirement age options, there would be no additional cost to the state. Relatively few employees would be expected to select the earlier retirement plans.

Chapter 16 - Approach 4

Replace Current Plan II Systems/Benefits with New "Split Plans" Which Reflect Typical Private Sector and New Federal Employees Retirement System Plan Design.

Description:

Create a new retirement system which includes both an employer-paid basic defined benefit pension and an employer- and employee-funded defined contribution account.

Employer-funded basic defined benefit plan:

Under this approach, the employer would provide a "basic" retirement pension which would provide a basic level of financial security when combined with Social Security benefits. The normal retirement age for the basic pension would remain the same as the current Plan II systems. Most other provisions of the basic pension would also be identical to current Plan II provisions, except:

(1) The benefit would be paid totally by the employer;
(2) The benefit would be based on a 1% formula;
(3) The benefit would "vest" after 10 years; and
(4) Terminated, vested benefits would receive annual increases such as discussed in Approach 2.

Employee- and employer-funded defined contribution plan:

This approach would also include a mandatory defined contribution plan. Employees would contribute 6% of compensation to a defined contribution plan, a level roughly equal to an average of the current Plan II employee contribution rates. All employers would contribute an additional 1% of compensation, which, when combined with the cost of the employer-paid basic pension, would be only a little more expensive than the current state cost for the Plan II systems.

In addition, local employers would be permitted to contribute an additional amount for LEOFF employees to pre-fund "retirement bridge" benefits.

The benefits would be payable upon the same conditions and in the same forms as discussed in Approach 5.

Advantages:

(1) Provides increased value for employees who change jobs before retirement.
(2) Provides increased flexibility in the timing and structure of payments from the

defined contribution plan.

(3) Reflects the retirement benefit design most widely used by larger private sector companies and the new Federal Employees Retirement System.

Disadvantages:

(1) Retirees take on investment risk for the defined contribution part of their benefits.

(2) For a given level of funding, benefits generally will not be as generous for those who work until retirement because more value is provided to employees who leave prior to retirement.

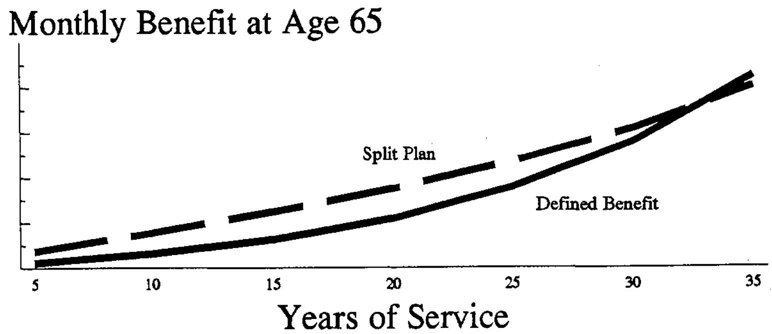
Cost:

This approach would probably involve a small increase in employer pension costs (less than 1% of pay). The difference between the cost of providing the new defined benefit plans and the current employer cost for the Plan II systems could be defined as the amount committed to the defined contribution account as the employer contribution.

This approach could be made more or less expensive by altering the defined benefit design, or by changing the level of employer contributions to the defined contribution account.

Figure 22

Example - Monthly Benefit Payable at Age 65
Comparison of Defined Benefit (Plan II) vs.
"Split Plan " (1% DB plus 7% DC)



Assumptions: Starting salary of $20,000;
Average salary increases. Hired at Age 30.

Chapter 17 - Approach 5

Replace Plan II Systems with Defined Contribution Plan

Description:

Replace the Plan II systems with a defined contribution retirement plan closely modeled after the TIAA-CREF plan for higher eduction faculty, but with contribution rates that reflect the average Plan II contribution rates (approximately 6% from both employees and employers). Contributions would vest immediately to the member and would earn market rate interest.

Benefits could be made payable in the form of a regular or variable monthly allowance (annuity) for life, such as in TIAA-CREF. If there were a desire to provide more flexibility, the benefit could also be paid in a variety of other forms such as an annuity for a fixed period, a rollover to an IRA, or as a lump sum payment. Spousal consent could be required for payments that did not include a survivor benefit.

Advantages:

(1) Employees who change careers prior to retirement receive full value for their early periods of service.
(2) Employees have greater flexibility in deciding when to retire and in structuring the payout of their retirement benefits.
(3) Employees are more likely to appreciate the value of their retirement benefits.

Disadvantages:

(1) Employees would take on the risk of poor investment returns. If investment experience were poor, retirees might complain that employees who provide identical periods of service receive different retirement benefits.
(2) If retirees are provided flexibility in their payout options, they could outlive their retirement savings.
(3) For a given level of funding, those who stay until retirement will, on average, receive smaller benefits than under the Plan II defined benefit design.

Cost:

A defined contribution plan could be implemented with whatever levels of employer and employee contributions were desired. The current Plan II contribution rates are:

	PERS II	TRS II	LEOFF II
Employee	4.85%	6.70%	7.01%
Employer	4.85%	6.70%	4.21%
State	---	---	2.80%

Under the proposal, identical employer and employee contribution rates would be used for all Plan II members. The employer rate would be set at a level equal to the current average employer contribution, about 6%.

Contribution rates would have to be increased, especially in PERS, to provide benefits at retirement equal to those generated by the Plan II systems. This would be necessary due to the loss of the indirect subsidy of Plan II retiree benefits which is currently provided by members who leave prior to retirement.

Rates would be stable and predictable, as compared to the Plan II defined benefit plans.

1 Introduction

Satisfying the needs of all parties is the goal sought when adopting policy positions. The attainment of goals, however, is seldom if ever fully achieved. Such a shortfall occurred in 1977 in ratifying the policy of Plan II of the Washington State Law Enforcement Officers' and Fire Fighters Retirement System (LEOFF), Public Employees' Retirement System (PERS), and Teachers' Retirement System (TRS).

A specific example is found in the policy position of the attainment of age 65 in PERS and TRS and age 58 in LEOFF to be eligible for the normal retirement benefit. Almost from its adoption, employee groups have opposed this age level of eligibility and have been seeking to reduce it. This opposition has intensified over the years as the Plan II systems age. It is safe to say that reduction of the retirement age is a prime annual lobbying objective of employee organizations. This desire to reduce retirement age has been reflected in the legislation these groups have been successful in having introduced over the years.

It is logical that as Plan II members age and their numbers increase, the pressure to address the retirement age and related issues will increase. The longer the legislature delays in resolving these issues, the more difficult and costly any change will become.

At its October 1990 meeting, the bipartisan Joint Committee on Pension Policy (JCPP) directed a study by its staff focusing on retirement age and related issues. (See Appendix A) The key elements of the study are as follows:

- Research and compile specific information about employee problems with, and perceptions of, the current Plan II retirement ages (age 58 in LEOFF, age-65 in PERS and TRS).

- Research and compile information on the impact of Plan II retirement age on employers covered by the systems.

- Identify and develop approaches to resolving employee and employer problems.

- Provide background information on demographics, Social Security, medical costs, etc. (See Appendix B)

- Investigate physical and mental limitations of age and service as a basis for early retirement.

- Study the role of employee and employer options.

- Recommend specific subjects for future study.

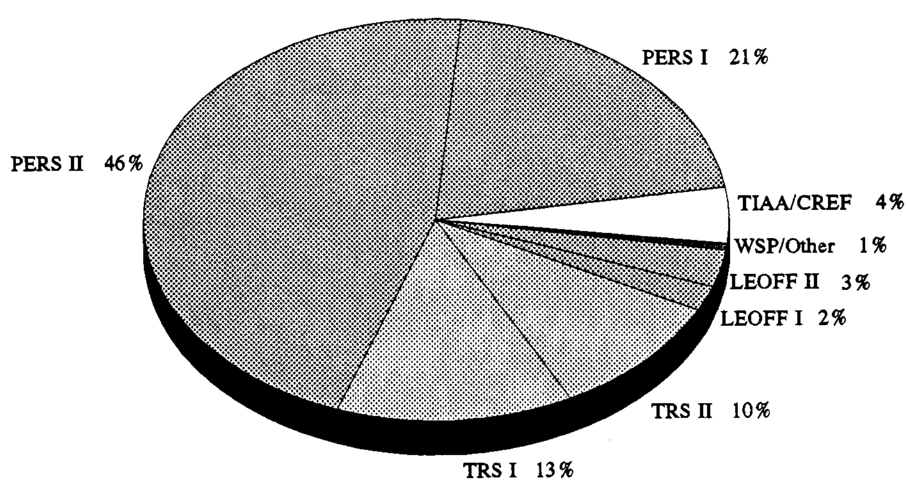
2 Washington's Retirement Age Policy - Overview

The State of Washington provides financial support for five major retirement systems. As Figure 2-1 indicates, three of these systems (PERS, TRS, and LEOFF) constitute 95 percent of the 223,758 members covered. Each of the three largest systems (PERS, TRS, and LEOFF) contain two tiers of membership denoted as Plans: Plan I consists of those first employed prior to October 1, 1977; and Plan II consists of those first employed on and after October 1, 1977.

Figure 2-1

Retirement Systems Funded by Washington State

Total Membership: 223,758



Role of Retirement Eligibility in Plan Design

Retirement plans are determined by the questions: Who gets a benefit? How much do they get? and When do they get it? The retirement eligibility age is a major factor in the answer to these questions.

Retirement eligibility is fundamental to the design of a pension plan. It should not be determined in isolation from other benefits or personnel policies.

The age at which older employees leave their jobs is determined primarily by retirement eligibility. As such, it determines the age distribution of the working employees and the age distribution of the retiree group.

The age and service distribution of working employees has a large impact on salary scales, promotional opportunities and disability benefits. On the other hand, the age distribution of the retiree group has a profound affect on the cost of protecting benefits against inflation and providing post-retirement medical.

Figure 2-2

Service and Disability Retirements
Age At Retirement

	LEOFF I	TRS I	PERS I
Age < 50	45%	1%	2%
Age 50 - 54	38%	14%	6%
Age 55 - 59	11%	36%	13%
Age 60 - 64	4%	41%	59%
Age 65 & Over	2%	8%	20%

Figure 2-3

Service and Disability Retirements
Current Age

	LEOFF I	TRS I	PERS I
Age < 50	21%	---	---
Age 50 - 54	14%	1%	1%
Age 55 - 59	16%	7%	3%
Age 60 - 64	23%	82%	88%
Age 65 & Over	26%	10%	8%

Plans with low retirement ages must deal with a workforce that is younger but also must deal with a retiree group that has younger retirees and therefore a much broader range of ages.

Figure 2-4

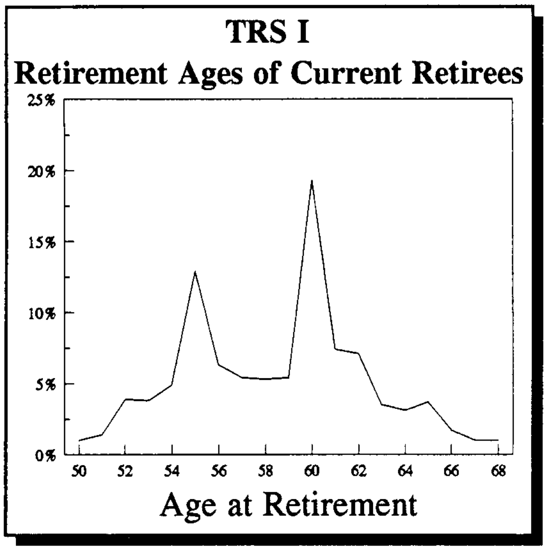
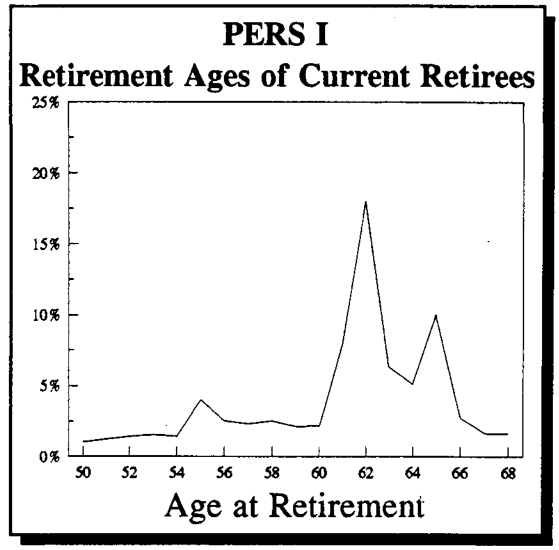


Figure 2-5



If an employer takes responsibility for the long-term welfare of its retirees (attempts to maintain a standard of living for members after retirement similar to before retirement), it cannot count on other benefit programs such as Social Security to bear part of the burden of income or Medicare to bear part of the medical costs prior to age 65. As such there will be great pressure to provide for substantial COLA's and pre-Medicare post-retirement medical. The longer the period of time over which a fixed percentage COLA is paid, the less likely it will be adequate. It is extremely costly to try to maintain the pre-retirement standard of living over a 30 or 35 year period.

Plans with high retirement ages, on the other hand, must deal with an older workforce and a retiree group that has a much narrower range of ages. These plans can count on immediate Social Security benefits and Medicare to augment retirement benefits. A fixed COLA is also more likely to adequately protect against inflation over a shorter retirement period.

With an older active workforce, such plans must accommodate those who cannot or do not want to work in the same job for their entire career as well as those who want to leave the workforce entirely.

Without some accommodation to their problems, people who want or need to leave their jobs cannot do so without destroying their retirement benefit. This will lead to constant pressure to allow earlier retirement as well as other benefit changes.

Plans built around careers such as teaching or the uniformed services tend to have few opportunities for changes of work assignments with the same employer or retirement system. These plans usually have the greatest demand for earlier retirement.

Retirement eligibility should not be viewed in isolation from other benefits of the plan, personnel policies and indeed the philosophy behind the entire benefit package.

<u>Career Plans</u>

Police and Fire Fighters

Historically, pension plans were created to satisfy the needs of certain careers. The first public plans covered police and fire, followed by teachers and then other public employees. Although there are plans which cover all of these groups together, most states have separate systems for these three groups. Career plans differ from other public plans in that their members are all involved in the same career and therefore have similar characteristics. These plans have developed to meet the special needs of their members.

Police and fire plans have developed somewhat differently than the other plans. They frequently involve not only retirement benefits but career protection as well. In other words, members whose police or fire careers are ended by illness or injury prior to normal retirement frequently receive a benefit similar to someone who has worked until retirement. Thus, when they can no longer perform the duties of their current occupation (occupational disability), they are retired and receive a benefit as if they had finished their career.

Although many plans limit the benefit to duty-related disability, the definition of "duty related" is usually extended to include many illnesses or conditions prevalent in the general population.

In recognition of the physical nature of the work, most of these plans have retirement eligibility standards that allow retirement at very early ages--frequently from 45 to 55. Although these ages are young in relation to other types of plans, they are really nothing more than the extension of the occupation disability standard, i.e., when they can no longer perform the duties of the job, they are retired. *Raising the retirement age while keeping an occupational disability standard would not significantly increase the age at which people retire.*

Because these careers historically have occupational disability and early retirement, they are frequently not covered by Social Security or included in Workers Compensation Benefits. In addition, because of the early retirements or disabilities, substantial COLA benefits are needed to maintain the value of their benefits over 30 or more years of retirement. Post-retirement medical benefits are often included since many are not covered by Medicare or it may be 15 or more years before Medicare eligibility.

In general, adopting the policy that members' careers should be protected and that the retirement benefit provided should be sufficient to sustain them during retirement, a necessary consequence would seem to be occupational disability, early retirement ages, substantial COLAs, and post-retirement medical benefits.

Teachers

The other career plans that have developed in most states are those for teachers. Although these plans have developed somewhat differently from police and fire plans, they are similar in several respects. They have relatively uniform characteristics: their members expect to retire at relatively young ages after some number of years of service; and there are relatively few opportunities to change jobs and remain with the same retirement system.

Although teacher plans usually have retirement eligibility similar to other public plans, teachers often spend most or all of their career in one retirement system and thus qualify for earlier retirement for long service more frequently than other public employees.

Those members who would change careers, whether because they cannot or do not wish to continue, have often already earned substantial retirement benefits. Since their new career is unlikely to be within the same retirement system, the only way to get any value from the benefit they have already earned is to receive an immediate retirement benefit.

Historical Development

General retirement policy in Washington, as in the United States, developed generally in three stages:

- First, police and fire of the major cities were provided pension benefits in the early 1900s;
- Soon after, retirement provisions were made for those in the teaching profession; and
- Finally, following World War II, remaining public employees were provided retirement coverage.

Separate chronological charts noting the above development for police, fire fighters, teachers and public employees are provided in Appendix C.

To understand previous retirement age policy, a closer look at the development of the systems is required. In doing so, a review will be made of general and specific factors which brought about the present study. This review will first look at the Plan I policy as it emerged and the reaction to it which brought about the Plan II systems.

Pre-1977 Systems

General Development of Problems:

Many changes were made in Washington's retirement systems in the period 1969 through 1977. Substantial benefit formula increases in PERS and TRS, lower retirement age criteria, shorter AFC period, the creation of a new police and fire retirement system to relieve local government, and the creation of a more generous Judicial system caused substantial increases in the State's financial commitment to pensions. This period also saw the beginning of the rise in inflation (6-1/4 percent per year for the 8 year period) and decreases in investment performance.

To understand the reasons for the creation and design of the Plan II systems, the following issues are important: economic context; abuses; legislative actions; leapfrogging; and judicial decisions.

Economic Context:

In the early 1970s several factors worked against the existing systems. First was the state's fiscal situation. A key part of these problems was the cost connected with retirement systems and, quite often, the failure to meet them. Major cities at that time, particularly New York, were undergoing severe financial problems and their systems had incurred large unfunded liabilities. New York's retirement situation was well publicized and caused concern throughout the nation. Finally, the inflationary spiral of the 1970s confounded almost all economists and certainly increased the cost of running government.

As earlier indicated, LEOFF was established in 1969. Cities were concerned they would not be able to support their systems in the future and sought to have the state resolve the problem. As a result, these systems were capped to new membership and the liabilities were assumed by the state. The liabilities of the capped local police and fire systems were estimated to be approximately $100 million. The contribution rates established were 6.0 percent of salary for members, 6.0 percent of salary by employers and the remainder by the state.

By 1971, the LEOFF unfunded liability doubled to $200 million. Several factors brought this about. First, the transferred liability was greater than anticipated. Second, the incidence of disability far exceeded the assumptions. Finally, the cost of the post-retirement adjustment also was greater than anticipated. All of these increased costs were being borne by the state general fund.

1975 LEOFF Valuation Results
Required Contribution as a Percentage of Pay

Member:	6%	**Employer:**	6%	**State:**	52%

By 1975 the unfunded liability was over $700 million. Although the disability benefit was expensive, it accounted for only about 1/3 of the total cost. The other provisions--early retirement, full CPI COLAs and automatic Joint and Survivor benefits added heavily to the cost. These costs did not include the short-term disability and post-retirement medical benefit cost paid by local government.

Locally, Washington in the late 1960s and early 1970s was in the throes of a recession with heavy layoffs at the Boeing Company. Although revenues increased briefly toward the end of the decade, alarming reports of retirement problems across the nation were identified and linked with the problems of LEOFF I. From the 1973-75 Budget to the 1975-77 Budget, the State's appropriation for pensions increased by 93 percent. Many legislators, reacting to these factors, became deeply concerned.

Abuses:

One of the principle stated reasons for change arose from perceived abuses within LEOFF I disability. Disability in LEOFF I, as defined by the courts, meant the inability to perform police or fire duties with average efficiency. This definition of disability is much easier to satisfy than that in Workers Compensation. (See Chapter 8)

Disabilities account for over 60 percent of the retirements in this system. Even granting the potential hazards of police and fire duties, this far exceeded original estimates. There were reported incidents of persons receiving disability retirement and engaging in strenuous work in other employment. Newspapers carried articles and editorials deploring such "abuses."

Legislative Actions:

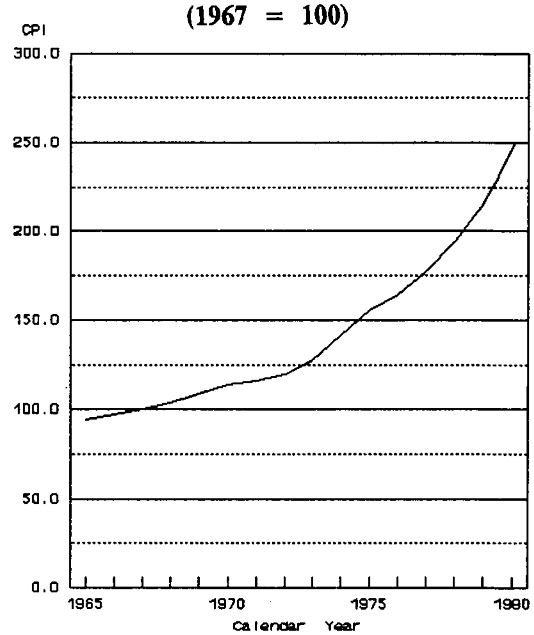
Benefit Increases. After the creation of LEOFF I, the 2.0 percent formula was introduced into PERS and TRS. This was a substantial increase in benefits and significantly increased the unfunded liabilities.

At the same time, the retirees of PERS and TRS were seeking cost-of-living adjustments (COLAs). As noted, an inflationary spiral was in effect from 1970. (Figure 2-6) Those who retired prior to the 2.0 percent formula were beginning to feel the devaluation of their benefits. During the period 1970 through 1977, several bills were introduced seeking COLAs.

Fiscal. In several bienniums, both in the governor's budget recommendations and in the adopted biennial budget, retirement funding suffered as a result of inadequate revenue. These actions, of course, significantly increased the unfunded liability.

Figure 2-6

CONSUMER PRICE INDEX (SEATTLE AREA)
Urban Wage Earners and Clerical Workers
(1967 = 100)



Leapfrogging:

Leapfrogging was one of the major problems experienced during this period. Leapfrogging occurs when two or more retirement systems take turns obtaining better benefits than the other. One can see indications of this pattern in the revisions to retirement age eligibility as outlined in Appendix C. Pages 3 and 4 of Appendix C show that PERS would obtain a benefit revision, only to soon be followed by TRS.

This practice allows benefits to be increased without recognizing the ultimate cost when they are extended to other groups.

Judicial Decisions:

The Washington State Constitution has been interpreted to prohibit the legislature from making corrections when a mistake is made in giving a benefit. The State Supreme Court, most notably in <u>Bakenhus v. City of Seattle</u>, has held that the retirement statutes created contractual rights on the behalf of members. It has interpreted these rights broadly, as binding the state not only to the benefits that have already been earned, but guaranteeing that employees can continue to earn benefits under the most favorable set of benefits in effect during their working career. Therefore, if the legislature reduces benefits for current members without providing an offsetting increase in other benefits, it is likely to find its change overturned as an impermissible "impairment of contract."

This interpretation allows the legislature no flexibility in adjusting pensions to fit changing economic and social climates. A pension plan adopted today for a 20 year old employee may be in effect for 70 or 80 years. Any bill that is written in error or poorly thought out may create rights that cannot be altered. LEOFF I falls into that category.

There is no prohibition, however, to continuing that set of benefits for current employees and providing a new set of benefits for those employed on or after a later date. The legislature's *lack of flexibility to take any corrective action in response to the problems of the Plan I systems required that there be new systems developed and that they be designed in such a way as to minimize future risks.*

1977 to Present

As a result of the problems experienced and the reality of the legal situation, the legislature worked about five years in studying and developing policy regarding retirement. Finally, effective October 1, 1977, a major policy revision was implemented for LEOFF, PERS and TRS, creating a Plan II for each of these systems. Figure 2-7 shows the fundamental difference in the normal retirement requirements and benefits for Plans I and II.

Figure 2-7

System	Normal Retirement Age/Years of Service	Normal Retirement Benefit	Duty Disability
LEOFF I:	50/5	Service x Annual Salary x 2% (At least 20 Years Service)	50% of Annual Salary
LEOFF II:*	58/5	Service x Annual Average of Highest 5 Yrs. x 2%	Industrial Insurance, and Accrued Retirement Benefit
PERS I:	60/5; 55/25; or Any Age/30	Service x Annual Average of Highest 2 Yrs. x 2%	Industrial Insurance, and Accrued Retirement Benefit
PERS II:*	65/5	Service x Annual Average of Highest 5 Yrs. x 2%	Industrial Insurance, and Accrued Retirement Benefit
TRS I:	60/5; 55/25; or Any Age/30	Service x Annual Average of Highest 2 Yrs. x 2%	Industrial Insurance, and Accrued Retirement Benefit
TRS II:*	65/5	Service x Annual Average of Highest 5 Yrs. x 2%	Industrial Insurance, and Accrued Retirement Benefit

* First hired on or after 10/1/77.

The adoption of Plans II set forth the following implicit policy:

- Retirement benefits are only paid at an age when employees are generally presumed to permanently leave the workforce.

- The Plans provide an adequate initial benefit at retirement for a long-service member.
- The benefit will be annually adjusted to assist in retaining the original purchasing power of the benefit.
- All public employees receive identical, or at least very similar, benefits to reduce "leapfrogging" pressures.
- The contribution is shared equally by the employer and employee, as a way to reduce constant pressure for benefit enhancements.
- The retiree's benefit is secure - not dependent on the economy or financial markets, nor on the judgement of the retiree.
- To ensure the benefit is used for retirement, the member is given few options in how it is received.
- Disability and death benefits are insurance concerns and not part of a retirement system.

As can be seen, in enacting Plan II the major problems experienced in prior years were addressed. It is important to understand the reasoning behind this revision.

Benefit Received when Leaving the Workforce:

"Retirement has been defined in a variety of ways as including older persons who:

"(1) Classify themselves as retired;
"(2) Receive Social Security or private pension benefits;
"(3) Have left their primary job;
"(4) Work less than a specified number of hours per year;
"(5) Experience a substantial reduction in earnings with or without a corresponding decline in work hours; or
"(6) Do not participate in the labor force.

"The lack of consensus on a single definition demonstrates the difficulty in characterizing retirement as a discrete event."[1]

In Plans II, the retirement age was established as the time when the member was presumed to *leave* the workforce. It broke the well-established tradition in Washington

[1] The Work and Retirement Patterns of Older Americans, Employee Benefit Research Institute (EBRI), December 1991. Page 3-4

of providing this benefit, in general, after completion of a career.

The policy rationale is simple. The retirement system is to provide a benefit for retirement when the member leaves the workforce, not when they leave their career. This age is generally accepted as age 65, as established by Social Security. Therefore, if the purpose of the retirement benefit is to sustain the individual in retirement, then it should not be given until that time. The major exception to the age 65 assumption was granted for uniformed personnel. Here age 58 was provided and it is a tacit recognition of the fact that there are some physical limitations in performing police or fire fighting duties.

The implied assumption in this policy is that the Plan II members' careers will be longer or may be extended elsewhere or that a new career option will be pursued. However, the retirement benefit will not be paid until the member is presumed to leave the workforce.

It should be noted that an early retirement option is provided. However, the entire cost of early retirement is borne by the retiree. First, the member must have attained age 55 in PERS and TRS or age 50 in LEOFF, and have 20 years of service. The benefit, however, is reduced approximately 8.0 percent for each year under age 65 or age 58 in LEOFF II.

Figures 2-8 and 2-9 demonstrate the difference Plans II make in the number of years the average retiree works versus the average number of years in retirement.

Figure 2-8

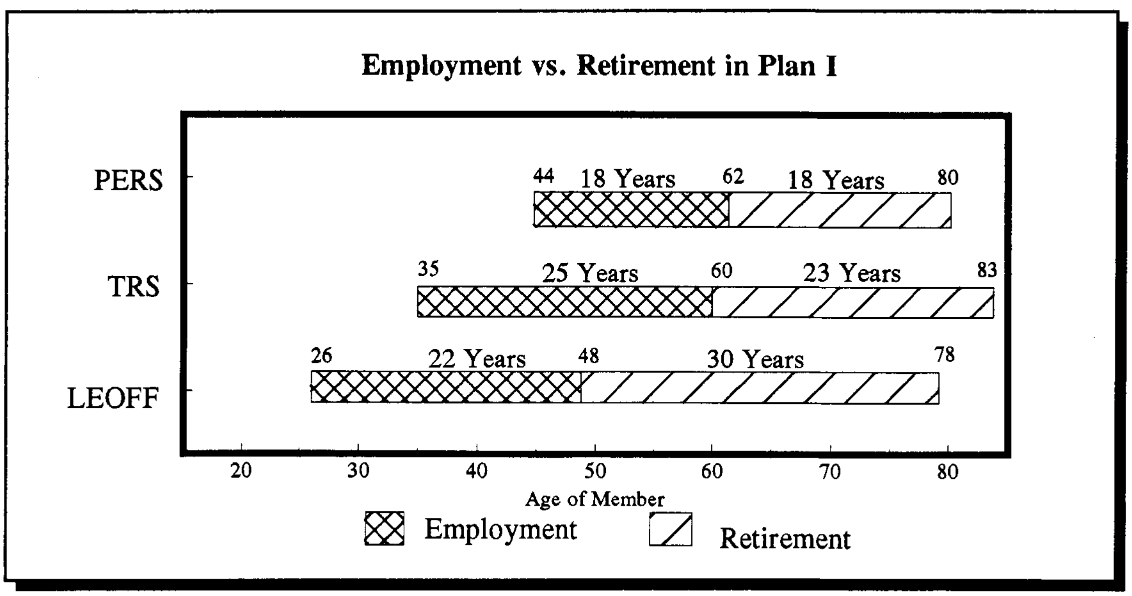
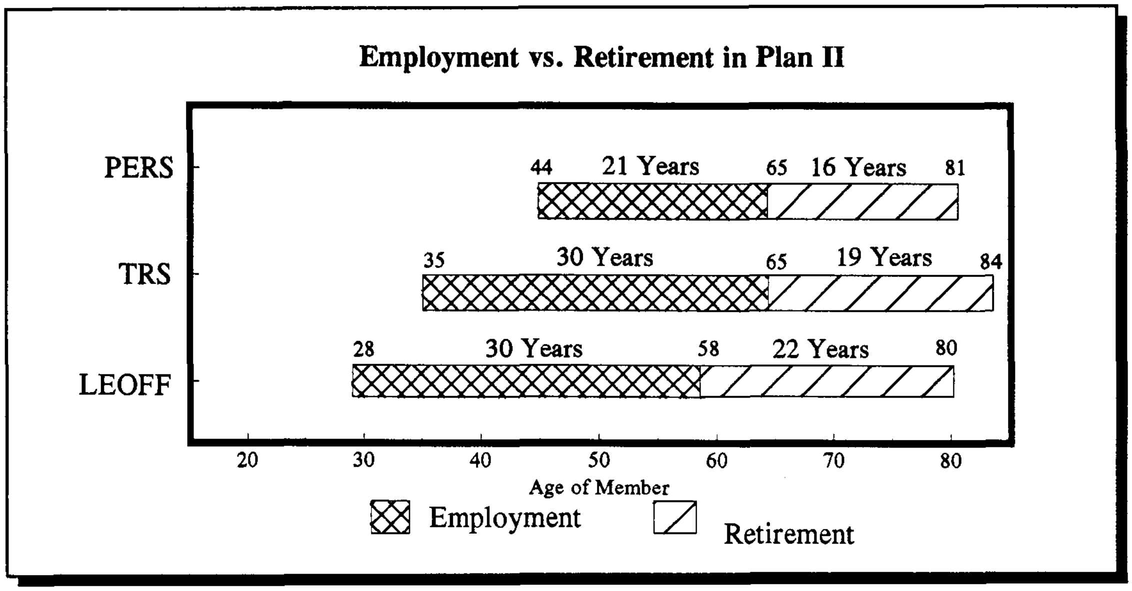


Figure 2-9



Adequacy of Benefit:

One of the concerns in establishing a system is the adequacy of the benefit. The President's Commission on Retirement Policy estimated retirees would need between 60 percent and 75 percent of final salary to maintain the same standard of living. Plan I TRS or PERS retirees, with 30 years of service will receive 60.0 percent of final average salary. In addition, most are eligible to receive between 25 percent and 40 percent of final salary from Social Security at age 65. In other words, such a member retiring at age 65 with 30 years of service would replace *at least* 85.0 percent of pre-retirement salary.

Most Plan I employees retire earlier than age 65 and with less than 30 years of service. However, higher Plan II retirement ages will result in longer careers. Since Plan II has no 60.0 percent cap on benefits as exists in Plan I, it can provide an even more generous benefit for many retirees.

Retention of Purchasing Power:

The legislature recognized the plight of retirees caught in inflation without provision for preserving the purchasing power of the retirement benefit. Their response was the provision of a pre-funded annual post-retirement adjustment of up to 3.0 percent in Plans II.

Leapfrogging:

The legislature determined that the Plan II provisions should be as similar as possible. It did not desire further leapfrogging to occur. Although the plans have almost identical provisions, three separate plans still exist. The attempt to create a single consolidated system failed in 1975.

Cost Sharing:

Members and employers are to share equally in the total contributions required to fund the system. Therefore, employees seeking future benefit increases will be required to pay half of the contribution rate increase if successful.

Although the contributions are shared equally, it must be remembered the employer pays for more than half of the benefits. When an employee terminates and withdraws her/his contributions, the employers' funds are not returned. Those contributions stay in the fund to pay benefits to those who do retire and thereby lower both employee and employer future contributions. Although the employees share equally in the contribution rates, individual employees pay for much less than half of their benefit.

The more turnover a system has, the lower the contribution rates and the smaller the portion actually funded by the employee. PERS has a good deal more turnover than TRS or LEOFF and therefore has a contribution rate substantially lower.

Paternalism:

Usually inherent in a defined benefit plan is the concept of "paternalism." The benefit is determined by a formula (a promised percentage times years of service times some salary base). The employer is legally committed to provide the calculated benefit and assumes the full risk of having enough money to do so when payments are due. Members are usually permitted few, if any, choices as to form and timing of benefit payments (i.e., benefits are usually paid for life after satisfying retirement eligibility criteria). This is to preclude choices that could result in a diminished benefit during retirement years.

Disability and Death Benefits:

Another major deviation from previous policy, specifically in LEOFF, is the attitude toward disability and death benefits. Both are to be considered as insurance problems and better handled outside of the retirement programs. One major reason for this change was the inflexibility created by the courts with the "Bakenhus series" of decisions.

Uniformed personnel are placed under the coverage of Workers Compensation for duty disability. Non-duty disability for these employees, like all other public employees, is left as the employees' responsibility.

The disability and death benefits payable in Plan II are not designed to be adequate, but are meant only to pay the member for the service retirement benefit that has been earned. At older ages this may be quite substantial, but at younger ages it usually is trivial. In neither case is it designed to be sufficient.

Summary

Retirement eligibility is fundamental to the design of a pension plan. It should not be determined in isolation of other benefits or personnel policies.

Rapid increases in benefits in the early 1970s and the creation of LEOFF I significantly increased the state's concerns with pensions. Simultaneously, the economic climate dramatically accentuated the risks of final average plans with low retirement ages.

As the costs of these Plan I "career-based" systems were realized, the state sought to limit its risks and reduce future contributions.

The legal environment prevented the legislature from correcting the problems in the current plans and thus limited any solution to the creation of new plans for new hires.

The Plan II design addressed the problems of Plan I primarily by: changing from career-based systems to age-based systems; sharing the costs of the plan; adding a COLA; and including LEOFF II members in Industrial Insurance.

Plan II was designed primarily to address employer/state concerns. It was not developed at employee instigation or with significant employee participation. The only benefits included in Plan II not included in Plan I are the 3.0 percent automatic COLA and the unlimited benefit (no 60.0 percent cap).

3 Employee Concerns with Plan II Retirement Policy

Several groups have an interest in what benefits are provided by the retirement systems that cover public employees and how those benefits are funded. The major interest groups include:

- active public employees;
- retired public employees;
- local government and state employers; and
- taxpayers who ultimately pay for the benefits.

The state legislature and the governor are the two state policy-setting institutions which have the challenge of balancing the conflicting interests/desires of these groups.

The Retirement Age Study outline adopted by the JCPP directed staff to research and compile information about active employee problems with, and perceptions of, the current Plan II retirement ages. In the period between November 1990 and September 1991 staff conducted a survey of Plan II members, and met with, solicited written input from, and conducted a survey of employee organizations.

The information in this chapter reflects the input staff received regarding employee concerns with the Plan II systems. In some cases those concerns dealt directly with the Plan II retirement eligibility provisions, in some cases they dealt with related provisions, and in some cases they dealt with provisions which seemingly have no connection to retirement eligibility at all.

Plan II Members are not Satisfied with Plan II Benefits

Most Plan II members have not yet been impacted by the higher Plan II retirement ages. The Plan II systems are only 15 years old; most members are relatively young or began public service late in their working life. Figure 3-1 demonstrates the current age distribution of Plan II members.

Figure 3-1

Current Age Distribution of Plan II Members

	PERS II	TRS II	LEOFF II
Up to Age 30	17%	23%	32%
Age 31-40	29%	46%	55%
Age 41-50	30%	25%	12%
Over Age 50	14%	6%	1%

Figures 3-2 and 3-3 demonstrate many Plan II members have developed a negative perception of the Plan II systems as evidenced by a May 1991 survey.

Figure 3-2

In general, do you consider yourself satisfied or dissatisfied with your retirement benefits?

	PERS II	TRS II
Satisfied	12%	2%
Dissatisfied	52%	75%
Not Sure	36%	23%

LEOFF II members were not asked this question.

Figure 3-3

Do you feel you could provide yourself with a better retirement income through a different means of savings or investment?

	YES
PERS	44%
TRS	51%
LEOFF	60%

From the written comments included with the survey, it is clear that a major cause of these reactions was the lack of value provided to members who terminate prior to retirement.

Clearly, Plan II members are dissatisfied with their current system. Over half of teachers and LEOFF members felt they could do better without the system at all. One-quarter of the teachers and over one-third of the LEOFF members would like to take their money out now and leave the system. From the written comments returned with the surveys, it is clear that most felt the retirement age is too high and the actuarial reduction so great as to prohibit any flexibility in leaving employment early.

The low rate of interest paid on member contributions (currently 5.5 percent) elicited many comments. For some, this is viewed as the only benefit they will receive from the system. Most of the negative comments can be characterized as being dissatisfied with the value they receive from the system if they leave prior to age 65.

The Plan II member survey did not ask members to identify specific concerns; it was expected that the employee organizations would have a better understanding of retirement benefits and would therefore be better able to articulate specific concerns and proposed specific changes. (See Appendix D-3)

Employee Organizations Want Career-Based Retirement

A major effort was made to solicit input from more than 20 organizations that represent a wide variety of public employees, including teachers, classified school employees, law enforcement officers, firefighters, correction officers, fisheries patrol sergeants, state patrol officers, and a range of local and state government general employees. Organizations were provided several opportunities to share their concerns about the Plan II retirement age policy, to propose what policy basis and assumptions should underlie any changes, and what information should be reviewed as part of the study. Input was solicited through a group meeting, individual meetings, requests for written input, and a formal survey. (See Appendix D-3)

Very few of the employee organizations showed an interest in providing much input; most declined to respond to the request for written input; and only a few provided any guidance regarding what policy guidelines should be followed in considering possible changes to the Plan II retirement eligibility criteria. The input which was provided showed, not surprisingly, a wide range of views and recommended changes to the retirement eligibility criteria. Unfortunately, the responses from some organizations to the survey were internally inconsistent, leaving an uncertainty as to what to report.

The general policy most often proposed by the organizations seems to be that employees should be able to "retire" and receive benefits when they are ready to leave their current occupation, i.e., when they leave their career rather then when they leave the workforce permanently:

(1) LEOFF--after working 20-25 years, and/or age 50.
(2) TRS--after working 30 years, and/or age 55 or 60.
(3) PERS--after working 20-25 years, at any age.

LEOFF Organizations - Presumed Physical Limitations Justify Early Retirement

All of the organizations representing public safety employees indicated that their members ought to qualify for a pension after they have worked 20-25 years, or at age 50 after working fewer years. The most common reason offered by these organizations to support such early eligibility for "retirement" benefits was that the employees they represent will not be physically able to carry out the duties of their current occupations. Some feel that their members deserve a "retirement" benefit after working 20+ years, because of the stress of public safety work.

The implicit policy behind this position seems to be that public safety employees should be able to collect a lifetime pension once they are not physically or emotionally able to continue in their current occupation, even though they have not yet reached an age when they are likely to be withdrawing from the workforce.

TRS Organizations - Occupational Stress Justifies Early Retirement

The organizations representing teachers take a similar approach, but believe that teachers can work longer careers (30 years, versus 20-25) and/or to later ages (55 or 60, versus 50) before they should be eligible for a retirement benefit. Once again, the most common reason offered to justify early retirement is that teachers will not be physically or emotionally able to carry out the duties of their current occupation until the Plan II normal retirement age (65). However, in the case of teachers, the focus is much more on the emotional demands (stress) of the job, and less on the physical demands.

The most common policy rationale seems to be that teachers should be able to collect a "retirement" pension at ages prior to when they could be expected to permanently leave the workforce. They are likely to be stressed out, burnt out or bored after teaching for 30 years, and should be eligible for a (lifetime) pension. The other common rationale for permitting retirement after 30 years is that teachers deserve a lifetime pension as a reward for providing 30 years of service.

In public testimony before the House Appropriations Committee in 1992, employee organizations supported further enhancements of the TRS I retirement eligibility criteria to allow retirement after 25 years service and at age 50 with 20 years service. The reductions were justified partially on the basis that many teachers were "burnt out" or "stressed out" after 20+ years of teaching, and ought therefore to be able to "retire."

PERS Organizations - Retirement After Providing 20-25 Years of Service

PERS members are employed in thousands of different jobs, with widely varying duties and demands, and are therefore difficult to characterize. However most of the organizations that represent PERS members indicated that their members should be able to retire after 20 or 25 years of service. Several of these groups also stated that those PERS members who worked in "high stress occupations" should be able to retire earlier than employees in other occupations.

In the survey, virtually all the organizations representing PERS and TRS employees indicated that all public employees should have the same retirement benefits.

All of the organizations representing public safety employees indicated that different groups of public employees should have different retirement benefits, depending on the type of work they perform.

PERS Organizations - Plan II Benefits Do Not Provide "Reasonable Value" to Employees Who Leave Prior to Retirement

This concern was expressed strongly in a letter from one of the larger organizations representing PERS members, which complained that PERS II was based on the invalid assumption that employees can, or should, be expected to stay with the same employer for 30 to 45 years. Nine organizations which responded to the survey believed that more of the resources of PERS II, TRS II, and LEOFF II should be allocated to providing benefits to employees who leave covered employment prior to qualifying for normal retirement; only three organizations (two of which represent LEOFF members) did not agree with that policy.

This appears especially to be a concern for employees who do not expect to stay in covered employment until normal retirement age.

The responses to the Plan II member general survey, especially the written comments, showed a high degree of concern on two issues: disability and interest credited on member contributions.

Disability Benefits:

Many members are concerned about the value of the benefit provided when they are forced to leave employment prior to retirement due to disability. LEOFF II members indicated in their survey they were more concerned about their duty disability benefits than their service retirement or other benefits. (See Appendix D-2) From the written comments, it was clear that many, and perhaps most, LEOFF II members are not happy with and, in some cases, do not understand what duty disability benefits they are eligible for through Industrial Insurance.

For example, the comments suggest that many mistakenly believe that the duty disability benefits paid to LEOFF II members are uniformly lower than those which had been provided under LEOFF I. Other members appear to have a better understanding of the benefits, but are unhappy with Industrial Insurance benefits because they want to be eligible for a pension if they cannot carry out their law enforcement or fire fighting duties (occupational disability). Industrial Insurance benefits are only paid long term when a person cannot carry out any occupation for which they are reasonably qualified by education or training.

Low rate of return on contributions:

One of the concerns most frequently cited in the Plan II members survey was the rate of interest credited on member contributions. For those members who do not expect to stay until retirement, the only value to the Plan II systems is the interest credited to their contributions. As shown below, it is estimated that only 20 percent of the PERS members that enter at age 25 will stay for 30 years.

	PERS	TRS	LEOFF
Entry Age 25 -- Probability of Staying 30 Years	20%	50%	70%

The interest rate has been 5.5 percent for several years; during the 1980s CD rates sometimes exceeded 10 percent but are now near 4 percent. Investment returns earned by the State Investment Board (SIB) have averaged over 15 percent for 12 years.

Members who do not stay until retirement actually lose value in saving towards their retirement when investment rates exceed 5.5 percent.

PERS Organizations - Plan II Benefits Provide No Flexibility in the Form and Timing of Pension Benefits

The employee organizations expressed this concern in several ways. Most of the organizations, including the largest organizations, indicated in the survey that the state should provide retirees with more options regarding the form of their benefit payout, including allowing retirees to receive lump sum cashouts of their benefits. The concern was also raised in written input.

The Current Plan II Systems Address the Concerns of Future Retirees

There are only about 1,500 Plan II retirees at this time. It is likely that future

PERS II and TRS II retirees will be content with their benefits once retired. The Plan II benefits include:

- Generous 2 percent formula;
- An automatic COLA to offset most of the inflation which is likely to occur during the period of retirement; and
- No maximum benefit.

All TRS II and most PERS II members will also qualify for Social Security and Medicare benefits at or soon after retirement. The combination of Plan II benefit, Social Security, and Medicare should provide the long-term employee with an adequate, secure, reasonably protected retirement benefit.

LEOFF II retirees may not be as satisfied. The 3 percent COLA may not be sufficient over 25 to 30 years of retirement. Because of a longer payout period, they are at greater risk for loss of purchasing power due to inflation. Some are not covered by Social Security and Medicare, however, many police are either covered by Social Security or a Social Security replacement plan (See Appendix E). All police and fire fighters hired after 1985 are covered by Medicare.

Summary

As an essential factor in conducting the JCPP-directed Retirement Age Study, active and retired employees and the organizations which represent them were surveyed for the purpose of determining attitudes, perceptions, and concerns with Plan II.

Most members were dissatisfied with the provisions of Plan II.

While an excellent response rate was achieved among individuals surveyed, some employee organizations were unresponsive.

Based on the input received, it is believed that the following represent the major sources of dissatisfaction:

- Normal retirement ages are set too high;
- Early retirement reduction factors are punitive;
- Employees who leave before retirement do not receive reasonable value;
- Interest credited to member accounts does not reflect either market rates or actual earnings;

- No flexibility in form or timing of pension benefits; and
- LEOFF members particularly concerned about duty disability benefits.

Factors leading to the specific areas of dissatisfaction are:

- LEOFF - Occupational disability justifies early retirement;
- TRS - Occupational stress justifies early retirement; and
- PERS - Some occupations have stress-justifying early retirement.

Implicit in the employee and employer organization positions is that retirement systems should be career-based and defined in terms of age and/or service after which the employee is entitled to a pension for life which has built-in inflation protection.

4 Employer/Taxpayer Concerns with Plan II Retirement Policy

As part of its research JCPP, staff conducted thirteen interviews with a variety of the employers of PERS II, TRS II, and LEOFF II members. (See Appendix F) The purpose of the interviews was to:

- Provide employers an opportunity for input;
- Determine whether they anticipate, or have already experienced, any personnel management problems associated with the Plan II systems; and
- See if any personnel management adjustments had been made to accommodate for the Plan II systems.

Common Reactions from Employer Interviews

(1) Few were very knowledgeable of the Plan II benefit provisions and had not yet experienced much impact from the higher Plan II retirement ages;

(2) Most had given little thought to the long term implications of Plan II on their salary schedules or operations;

(3) Employers generally viewed the Plan II systems as a given, and felt no "ownership" of the benefits;

(4) Retirement benefits have no impact on the recruitment of employees;

(5) They did not suggest changing retirement ages, or otherwise raising benefits if it would result in higher costs;

(6) Burnout and job stress were not retirement issues, but rather were personnel issues not related to length of service or age;

(7) Retirement benefits tend to have a retentive impact only on those employees relatively close to retirement age; and

(8) It would be helpful to have some kind of benefit to assist employees in making career transitions prior to retirement.

LEOFF II employers were uniformly dissatisfied with the duty disability benefits provided by Workers Compensation. The "civilianization" of jobs in their departments was making it more difficult to find limited-duty positions for partially disabled employees.

TRS II employers generally conceded that they did use the early retirement provisions in TRS I to convince certain employees to leave; but most did not feel they needed retirement to deal with marginal employees. Sabbatical programs were useful, but under-utilized, to deal with job stress. They strongly supported benefits for employees who do not want to continue teaching to transition to other employment.

PERS II employers had a variety of perspectives, but none indicated that the retirement age would be a significant problem. Employers varied in their reasons for believing a retirement age of 65 (or 58) would not be a problem. Some state institutions have so much turnover that they have few employees at older ages. Other agencies, such as the Department of Corrections, allocate job assignments on the basis of seniority and older workers are able to choose assignments that are less physically demanding.

Workforce 2000

The Workforce 2000 Personnel Systems Study, by the Washington State Efficiency Commission (1990), examined "expected changes in the workforce, including the rising average age of state employees, increasing number of state employees eligible for retirement and the decreasing availability of entry level workers."

The Department of Retirement Systems published a Workforce 2000 report as part of the Efficiency Commission Study that examined the affect of retirement benefits on the recruitment and retention of state employees (See Appendix G). The report reached this conclusion:

> "These benefits have little affect in recruiting individuals into state service. The retention effect of PERS increases the closer the member gets to retirement, however, the incentive for continued employment is diminished once retirement eligibility is reached."

Competition for Tax Revenues

The Plan II systems would likely be relatively popular with both taxpayers and the recipients of other state-funded programs. Both would presumably appreciate:

- The lower cost of the systems, due in large part to the age 65 retirement and the low value provided to employees who leave covered service prior to retirement;

- The fact that the retirement eligibility criteria, unlike most public retirement systems, is not more generous than most private sector plans; and

- The benefit and funding features which help to control costs and limit risks - the 50-50 cost sharing, and the provision of almost identical benefits to all public employees to avoid "leapfrogging" pressures, etc.

Figure 4-1 reflects the cost savings resulting from the Plan II systems.

Figure 4-1

Estimated Savings Due to Creation of Plans II

	PERS	TRS	LEOFF	TOTAL
State & K-12				
1993-95 Biennium	$74 Million	$72 Million	$244 Million	$390 Million
25 Years	$2.8 Billion	$3.4 Billion	$9.7 Billion	$15.9 Billion

Summary

As part of the overall survey process, personal interviews were conducted with a wide ranging spectrum of employers of PERS II, TRS II, and LEOFF II employees. The most notable results were:

- Few had any depth of knowledge about Plans II;

- Little or no thought had been given to long-term implications on their operations or personnel policies;

- Consistent support for a system which would foster transition opportunities for their employees at little or no cost;

- No desire for changes which would add significant new costs;

- Unanimous belief that retirement plans have no impact on recruitment and limited impact on retention; and

- Uniform belief that stress is a personnel not a retirement problem.

The Workforce 2000 Personnel Systems Study reached the same conclusions on recruitment and retention.

Taxpayers and recipients of state-funded programs would presumably be supportive of Plans II due to the significant cost savings.

5 Federal, State and Private Sector Retirement Systems Review

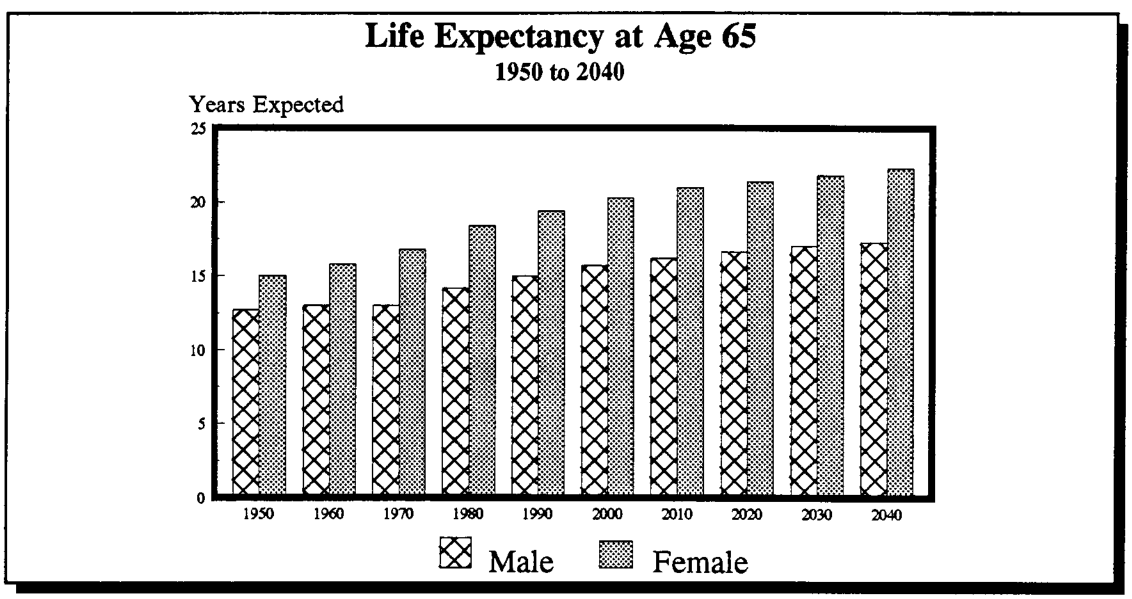
Public Sector Retirement Systems

Social Security and Medicare

When the Social Security program was created in 1935, the normal retirement age was set at age 65. Figure 5-1 demonstrates the increase in the life expectancy of Social Security recipients from 1950 to the present and projected to 2040.

One of the justifications for the creation of the Social Security program was to provide superannuated employees with a source of income so that employers would no longer feel morally obligated to keep them on the workforce.

Figure 5-1



Normal Retirement Age - 65, Increasing to 67:

The age at which employees become eligible for unreduced Social Security benefits was recently increased by Congress. Persons born before 1938 are eligible at age 65, those born between 1938 and 1959 are first eligible sometime between age 65 and 67, and all employees born after 1959 will be first eligible at age 67. Another way of stating this is that persons who reach age 65 after the year 2003 will be affected by the increase in the normal retirement age.

Figure 5-2

Social Security Normal Retirement Age
Current Plan II Members

	PERS	TRS	LEOFF
Age 67	14%	23%	44%
Between 65-67	72%	71%	55%
65	14%	6%	1%

Congress made these changes to the Social Security retirement age provisions in 1983 due to growing concerns about the fiscal status of the Social Security program. Substantial stress on the system is anticipated as the ratio of retirees to active employees shifts from 17.4 retirees per 100 active employees in 1965 to 21.8 in 1990 and to about 38 per 100 by the year 2030, and as life expectancies continue to increase.

Early Retirement Age - 62, with 20-30 Percent Reduction:

In 1961 (1956 for women) the program was amended to permit early retirement at age 62, with a benefit reduction of 20 percent from age 65. The change in 1983 did not raise the early retirement age, but adjusted the reduction factor to ultimately provide a 30 percent reduction from age 67.

A large percentage of employees elect to receive reduced benefits at age 62, and it is expected that they will continue to do so even after the benefit reduction increases to 30 percent. By contrast, the benefits of TRS II members who retire at 62 would be subject to a 27 percent reduction.

Figure 5-3

Social Security Retirement Ages

Retirement Prevalence Rates per 1,000 Fully Insured by Age, Sex, and Year

	Males				Females			
	Age 62	Age 63	Age 64	Age 65+	Age 62	Age 63	Age 64	Age 65+
1970	18%	22%	19%	41%	33%	30%	19%	18%
1980	30	28	19	23	42	29	16	13
1990	37	29	18	16	42	30	16	12
2000	39	29	17	15	44	30	16	10
2010	36	28	17	19	43	30	15	12
2020	34	28	18	20	41	31	16	12

As the chart above shows, currently over one-third of males, and over 40 percent of females elect to receive reduced benefits at age 62, the earliest age they are available. Over two-thirds begin their benefits by age 63. The Social Security Administration expects well more than half of retirees to begin their benefits by age 63 even after the year 2020. Thus, *the practical impact of the increase in the normal retirement age is expected to be mostly a reduction in the level of benefits paid to retirees, not a delay in the departure from the workforce.*

Medicare Eligibility Age - 65:

The age at which persons qualify for Medicare benefits has been age 65 since creation of the program in 1965. The program is currently experiencing tremendous cost pressures due to high medical inflation, and other factors. Since 1985 coverage in the Medicare program has been mandatory for virtually all newly hired public employees (including public safety employees).

More information regarding Social Security retirement eligibility criteria can be found in Appendix H.

Federal Employee Retirement System (FERS)

The Federal Employees Retirement System was created in 1986 as a replacement for the Civil Service Retirement System (CSRS). The system was developed after several years of hearings in Congress. There were two primary motives for creation of a new system: (1) a desire to bring federal employees into the Social Security program; and (2) a desire to reduce the high cost of the CSRS benefits. CSRS was a generous "career" type system which provided unreduced benefits, with a full COLA, at age 55 with 30 years service.

The new system is a combination of three benefits:

- Social Security benefits;
- a basic benefit (pension) plan (Figure 5-4); and
- a thrift plan. (Figure 5-5)

This type of plan mirrors to a great extent the most common private sector retirement plan design.

Figure 5-4

FERS Basic Benefit Plan Provisions

Pension Formula:	1% x Average Final Pay x Service; or 1.1% for Retirement at Age 62 with at Least 20 Years.
COLA:	Generally change in CPI minus 1%, after Age 62.
Employee Contribution:	.8%

Figure 5-5

FERS Thrift Plan Provisions

	Employee	Federal Government
Automatic:	0	1% of Pay
Optional:	First 3% of Pay Next 2% of Pay Next 5% of Pay	Match $1 for $1 Match $.50 for $1 0
Maximum:	10% of Pay	5% of Pay
Investment Options:	Government Securities Funds; Fixed Income Fund; and Common Stock Index Fund.	

The philosophy behind the change in plan design was explained in the following terms:

"For the first time, you [federal employee] will have a real voice in determining the structure of your own retirement plan...if you leave Federal employment you can take most of your benefits with you."[2]

Retirement Eligibility - Basic Pension - General Employees:

FERS members can receive an *unreduced* basic pension at:

- age 62, with 5 years service;
- age 60*, with 20 years; or
- ages 55-57* with 30 years.**

They can also receive a reduced basic pension at:

- ages 55-57 with 10 or more years;
  reduced 5%/year from age 62

* Members who reach the normal retirement age before age 62 are eligible for an additional "Special Retirement Supplement" payment until age 62. The supplement approximates the Social Security benefit earned by the member while employed by the federal government. No COLA is paid on the supplement.

** 10 yrs prior to Social Security retirement age.

Retirement Eligibility - Basic Pension -
Law Enforcement, Fire Fighters, Air Traffic Controllers:

Employees in a variety of public safety related jobs can receive an unreduced (1.7 percent) basic pension, and the Special Retirement Supplement at:

- age 50 with 20 years; or
- at any age with 25 years.

Employees in these job classes are generally subject to mandatory retirement at age 55 or 57.

Federal law makes the Office of Personnel Management (OPM) responsible for deciding which positions are entitled to the coverage of the special retirement provisions; in 1987 OPM delegated its authority to agency heads for employees covered by FERS. As of June 1987, about 4100 job classes, within 245 different occupational series, were covered by the law enforcement officer retirement program. Congress and OPM are frequently asked to expand the number of job classes eligible for the earlier, richer benefits.

[2] United States Office of Personnel Management, Retirement and Insurance Group (September 1986)

Retirement Eligibility - FERS Thrift Plan - All Employees:

Federal employees have great latitude in deciding when to withdraw their contributions from the Thrift Savings Plan. They may withdraw their funds if they retire, become disabled, die, or leave Federal service after being vested in the FERS Basic Benefit Plan (five years). Benefits can be received as an annuity, lump sum payment, or as a rollover to an IRA or similar plan. The size of the monthly annuity a retiree can purchase with his or her account balance increases each year that retirement is delayed. Defined contribution plans inherently promote delayed retirement.

Public Employee Retirement Systems in Other States

Retirement Eligibility:

Eligibility for any retirement benefit occurs when specific requirements are met. The requirements are based on either service or age, or a combination of service and age (e.g., retirement eligibility might be met if 30 years of service credited; attainment of age 65; 25 years of service credited and attained age 55). "Normal Retirement" is usually defined as the earliest age at which an unreduced benefit is available. Most states utilize a combination of age and service or service only to establish eligibility for retirement.

Currently, ten states are utilizing what is known as the *"rule of Y."* This is a service and age eligibility, but the sum of the numeric value of service and age must equate to a specific number. For instance, under a rule of 75, if a person were age 50 with 25 years service he or she qualifies. (See Appendix I, pp 5-6)

Normal Retirement Age - TRS/PERS Employees:

"Age 62 Normal...The current survey reflects that 50 of 85 systems would permit normal retirement at age 62 with 10 years or less. Actually, 75 of the systems in this study permit normal retirement at 62 with long service, and only 10 systems are tied to the age 65 normal retirement now found under Social Security. In fact, the most common normal retirement in the 1990 study is age 60 with 'X' years of service."[3]

"The normal retirement age...is an important indicator of the generosity of plan benefits. Teachers and regular public employees are more likely than private employees to be in plans with a normal retirement age under 65. 84 percent of teachers and 82

[3] The 1990 Comparative Study of Major Public Employee Retirement Systems, State of Wisconsin Retirement Research Committee Staff Report No. 79 (October 1990).

percent of other public employees are in plans with a normal retirement age under 65 or based solely on years of service."[4]

Reduced Early Retirement:

Actuarial Reduction Factors. The actuarial factors applied for early retirement compensates the plan for the longer, earlier pay-out period. Some systems (such as our Plans II) use a reduction table which reflects the actuarial adjustment that is required to compensate the pension system completely. Many of the systems in the 1990 study "subsidize" early retirement by applying reduction factors that are less than the full actuarial equivalent. A few systems do not provide early retirement because their normal retirement is already at 55 with long service (PERS I and TRS I.)

The actuarial reduction requirements for the various systems are summarized as follows:[5]

Figure 5-6

	Number of Funds
Discount rates less than 3%	1
Discount rates of 3% to 5.9%	22
Discount rates of 6% or more	22
Discount rates vary according to service or age	16
Employs actuarial discount table	12
Formula multiplier varies by age	4
Money purchase plan	1
No early retirement provided	7

Normal Retirement Age - LEOFF Employees:

It is very difficult to get reliable information regarding the retirement eligibility criteria used by retirement systems covering law enforcement officers and firefighters. The vast majority of such systems are administered by the local governments which employ such employees, and no regular comprehensive surveys are done of local government plans.

[4] Benefits and the Economy, Implications for State Education Associations, National Education Association Research Division (1991), page 11, based on US Department of Labor data.

[5] The 1990 Comparative Study of Major Public Employee Retirement Systems, State of Wisconsin Retirement Research Committee Staff Report No. 79 (October 1990).

However, according to a 1990 survey conducted by the International Association of Fire Fighters, the most common retirement eligibility criteria for fire fighters are:

- 20 years service (any age) (21%)
- Age 50 (with 5, 20 or 25 years service) (20%)
- Age 55 (with 5, 20 or 25 years service) (15%)
- Other/No response (44%)

It is likely that the retirement systems covering most local law enforcement officers have similar provisions.

These results are consistent with the conclusions of a 1978 Congressional report which found that police and fire employees were most often eligible for normal retirement at age 50 or 55, with 20 years service, or just 20 years service. Uniform service plans generally do not have provisions for early retirement. (See Appendix I)

Interesting Public Sector Plans

In conducting a review of the retirement age provisions of other state retirement systems, a number of state plans stood out for their departure from traditional public employee retirement benefit design. (See Appendix J)

UTAH

Non-contributory defined benefit plan:	No employee contribution; employer pays entire cost for the defined benefit plan.
Defined contribution plans, with employer contributions:	All employees are covered by both a 401(k) defined contribution plan and a 457 deferred compensation plan. Employer 401(k) contribution levels vary (1.5 percent for state and K-12 employees; optional for local government). Employee contributions are optional.
Normal Retirement Age:	65 with 4 years; 62 with 10 years; 60 with 20 years; any age with 30 years

Tennessee has a very similar set of plans; Arkansas, Connecticut, Florida, Michigan, Missouri, and Nevada also have non-contributory plans, but do not apparently have employer contributions to any defined contribution plans.

CALIFORNIA, HAWAII, VERMONT, AND MARYLAND

Non-contributory "basic" defined benefit plan: In each of these states the employer pays the entire cost of a "basic" pension:

- 1.25% formula in California, Hawaii, and Vermont
- 0.8% x first $18,600 of FAS plus 1.5% of FAS over $18,600 in Maryland

Defined contribution plans: Each state promotes optional employee contributions to 457 deferred compensation plans. Maryland and Hawaii also offer optional 401(k) plans.

Normal Retirement Age: Normal retirement ages are somewhat higher than average for public retirement plans:

- 65 with 5 years (California)
- 62 with 10 years, 55 with 30 years (Hawaii)
- 62 with 5 years, any age with 30 years (Maryland)
- 62 with 10 years (Vermont)

NEBRASKA

Nebraska has covered its general employees in two defined contribution plans since 1963.

Who is covered: State and county employees, including sheriffs.

Employee Contributions: 3.6% on first $24,000 of salary, plus 4.8% over $24,000

Employer Contribution: State - 156% of employee's contributions
County - 150% of employee's contributions

Normal Retirement Age: 55 with 5 years

WEST VIRGINIA

Who is covered:	All teachers first employed as of July 1991
Employee contributions:	4.5%
Employer contributions:	7.5%
Normal Retirement Age:	Age 55 with 12 years service

TIAA-CREF

As an example of pure defined contribution plans, TIAA/CREF provides retirement and tax-deferred annuity plans for colleges, universities, independent schools and certain other non-profit and tax-exempt educational and research institutions and their staff members.

Over 3,800 educational institutions have adopted retirement plans using TIAA-CREF retirement annuities for at least one retirement option for their employees. The standard plan is a defined contribution, money purchase retirement benefit which provides lifetime income for participants. Contributions are generally defined as a percent of income and applied to individual TIAA and CREF annuity contracts that are fully funded and provide for full and immediate vesting of all contributions.

Effective January 1, 1989, federal tax law prohibits the distribution of TIAA and CREF accumulations prior to the members reaching age 59.5, separating from service, becoming disabled or encountering hardship.

Figure 5-7

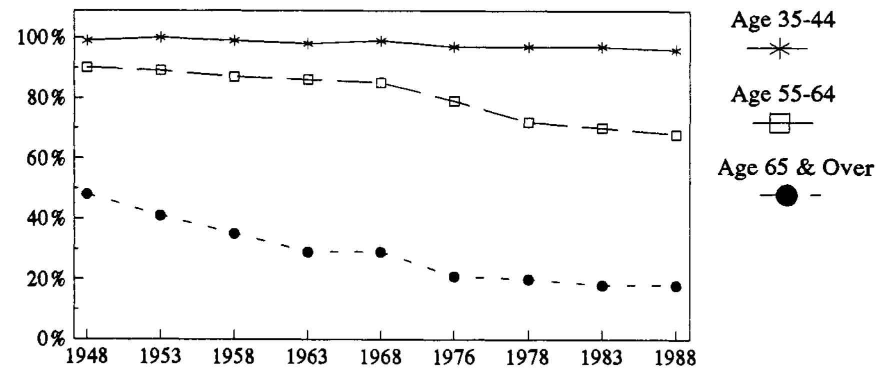
Washington Higher Education

Employee Contributions	Employer Contributions
5.0% through age 35 7.5% age 35 - 50 7.5% age 50 & up*	Matching Funds

* Employee has the option to increase contribution to 10.0%.

Figure 5-8

Male Labor Force Participation Rate by Age
Selected Years 1948-1988



Source: U.S. Department of Labor, Bureau of Labor Statistics, Handbook of Labor Statistics (Washington, DC: Government Printing Office, 1989).

Trends - Retirement Policy Schizophrenia:

Federal retirement and tax policies have increasingly taken the approach of encouraging workers to delay retirement. The raising of the age at which full Social Security benefits are paid, restrictions on payment of tax-deferred funds prior to age 59 1/2, expansion of the Age Discrimination in Employment Act, and similar changes have all been predicated on the assumption that it is in the nation's interest to reverse the declining labor force participation rates of older employees. (See Figure 5-8)

The new FERS system reflected this policy approach, albeit only to a small degree, with its increase in the minimum retirement age for long-service employees from age 55 to 57, and indirectly by movement of federal employees from a "career" based retirement design to a new design that includes a defined contribution plan and Social Security benefits.

Other state retirement systems appear to be moving in two contradictory directions at once. On one hand, according to the 1990 comparison done by Wisconsin Retirement Research Committee, there appears to be a trend towards permitting normal retirement at earlier ages - particularly for employees with long service. Seventeen of the 85 PERS in the study had recently reduced the age and/or service requirements for normal retirement.

On the other hand, a number of other states, including Minnesota, California, and Vermont, have raised their normal retirement ages in recent years. Minnesota raised its from 65 to the Social Security retirement age, California raised its (PERS) from age 60 to age 65, and Vermont raised its from age 60, or at any age with 30 years service, to age 62. However, some of the same states that have raised their normal retirement ages, have also adopted early retirement programs, usually in response to short-term budget pressures.

Washington state is a classic example of the evident policy schizophrenia. The Plan II retirement systems were adopted in 1977 with normal retirement age provisions that matched Social Security and reflect the federal policy of encouraging older employees to stay in the workforce. However, twice since then (in 1982 and 1992) the state has reduced the retirement eligibility provisions in PERS I and TRS I to allow some persons to retire in their 50s, and in some cases in their late 40s.

While there are two conflicting trends in terms of retirement age policies being adopted by states, it is clear the current Plan II retirement eligibility criteria provides for later normal retirement than most other state public employee retirement systems. This is especially true for TRS II and LEOFF II.

Private Sector Systems

Different Plan Designs

Most small private employers either do not cover their employees in any retirement plan, or only in defined contribution plans. Only about one-half of all private sector employees are covered by an employer provided retirement plan.

Most large private employers do cover their employees in retirement plans. Private sector plans vary much more in their designs than public sector plans; they use a wider variety of benefit formulas, eligibility and vesting criteria, etc. Few sources of detailed comparisons of private sector plans are available. However, from information collected by the U.S. Department of Labor and other sources, it is known that most medium and large private companies do include the following two elements in their retirement benefits:

- A non-contributory (100 percent employer funded), defined benefit plan; and

- A tax-qualified defined contribution plan, often with limited employer matching contribution. These plans are frequently referred to as "thrift," "thrift/savings," or "401(k)" plans (referring to the section of the federal tax code which authorizes such plans).

Legal Protection of Benefits

Only those benefits that have already been earned in private sector plans are legally guaranteed to members. Under federal law, private companies can terminate or alter their retirement benefits for current employees for future periods of service. In the 1980s companies removed $21 billion from their "over-funded" pension plans, often at the same time they reduced benefits for future periods of service. Private employers can also alter or terminate their 401(k) plans, with only the contribution already made belonging to the employee.

401(k) Plans - Rapid Growth in Popularity since 1982

In 1982 the federal tax code was amended to permit employers to provide defined contribution plans which included a variable, or matching employer contribution. Participation in such plans has grown dramatically. A 1991 survey by Massachusetts Mutual Pension Management reported that 57 percent of the companies surveyed sponsored such plans, an increase of 16 percent from 1988. A 1991 survey of fifty large U.S. industrial companies by the Wyatt Company indicated:

"Forty-four companies have thrift/savings or 401(k) plans... Three plans have fixed employer contributions... Twenty-four match employee contributions up to 6 percent of pay and 12 match employee contributions over 6 percent. Fifty and 100 percent are the most common employer matching rates. The most common maximum employer contribution is from 3 to 4 percent of pay...."

Companies in the Wyatt survey indicated that the participation rate for their non-highly compensated employees ranged from 27 percent to 91 percent and averaged 64 percent. The Massachusetts Mutual survey reported an average participation rate by non-highly compensated employees of 68 percent, and that participation rates and deferral rates were significantly higher in companies that provided matching contributions.

Figure 5-9

Company Match

Over 71 percent of plans provide for company matching contributions. The most common match across all size plans continued to be 50 percent. Overall, 20 percent of plans match employee contributions dollar for dollar, compared to only 12 percent in our 1988 survey. Plans most often match up to 6 percent of the employee deferral.

Amount of Match	None	25%	50%	75%	100%
	29%	12%	26%	2%	20%

Plan Participation

Plans with fewer than 1,000 employees experience better plan participation rates than larger plans, especially with regard to non-highly compensated employees. As will be noted later, respondents indicated that the most effective means of plan communication for encouraging enrollment is individual meetings. The fact that individual meetings are more feasible in smaller companies may be an explanation.

Participation Rates	Overall	≤ 250	251-500	501-1000	1001-5000	5000+
Highly Compensated	83	82	86	83	86	80
Non-Highly Compensated	68	72	69	73	62	62

Participation rates are also affected by the amount of company matching contribution. Respondents indicated that the greatest incentive for plan participation by non-highly compensated employees is the amount of company matching contribution, and this is confirmed by the data.

Amount of Match	None	25%	50%	75%	100%
Participation Rates					
Highly Compensated	70	88	88	88	85
Non-Highly Compensated	51	65	72	75	76

Mount of Match	None	25%	50%	75%	100%
Average Deferral Rates					
Highly Compensated	5.33	5.85	6.05	6.22	6.14
Non-Highly Compensated	4.13	4.25	5.14	5.46	5.34

Source: 401 (k) Survey Report, Massachusetts Mutual Life Insurance Company, July 1991

Although authorized originally as "profit sharing" plans, the IRS ruled that state and local governments could also sponsor such plans, until Congress eliminated the option in 1986. Some governmental units have created similar plans by offering variable matching contributions to employee deferred compensation plans (457 plans).

These plans have not been in place long enough to develop a track record regarding what percent of final compensation they would replace for a long-term employee.

Private Sector Plans - Normal Retirement Ages

About 45 percent of the private employees who are covered in medium and large company retirement plans may retire with unreduced benefits before age 65 (usually at age 62); about 40 percent are in plans with a normal retirement age of 65.[6]

In 1991 the Wyatt Company conducted a survey of the retirement and thrift plans covering salaried employees of 50 large U.S. industrial companies. The survey results indicated:

- <u>Total income replacement level</u>. Combined company pension and Social Security benefits are projected to range between a low of 36 percent of final salary to a high of 76 percent for persons who retire in the year 2026 at age 65 with 35 years of service. Under the projection, 27 plans will replace more than 60 percent of final pay, 7 plans will replace less than 50 percent, and the average of all plans will be about 58 percent (41 percent from the employer pension and 17 percent from Social Security).

- <u>Early Retirement</u>. Forty-four of 50 very large U.S. company plans surveyed in 1991 pay unreduced benefits at age 62; 23 pay unreduced benefits at age 60; and 11 pay unreduced benefits at age 55.

- <u>Benefits at age 62, 60, and 55</u>. Thirty-six plans replace between 35 and 44 percent of final pay when retirement occurs at age 62 with 32 years of service; 32 plans replace between those levels when retirement occurs at age 60 with 30 years service; 35 plans replace at least 20 percent (up to a high of 34 percent) when retirement is at age 55 with 25 years service.

Reduced Early Retirement

The Wyatt study also reported on the reduction factors that employers used to calculate early retirement benefits. Early retirement reduction factors are often more complicated in the private sector plans, often involving different rates for different ages and a separate rate for the Social Security offset. The following table is an attempt to simplify the most prominent reduction factors used in the plan for general comparative purposes.

---

[6] <u>Benefits and the Economy, Implications for State Education Associations</u>, National Education Association Research Division (1991), page 11, based on U.S. Department of Labor data. Copyrighted Report

Figure 5-10

	Number of Funds
Discount rates less than 3%	4
Discount rates of 3% to 5.9%	27
Discount rates of 6% or more	8
Actuarial discount table	3

Projected Benefits, with Income from Thrift Plans

Thrift plans are relatively new; it is not clear what level of benefits will result. The Wyatt Company projected under current contribution levels the largest U.S. company plans will replace an average of 25 percent of pay from employer contributions and 36 percent of pay from employee contributions. These contribution levels are not guaranteed to continue. (See Appendix K)

Summary

Our survey included a review of the plans of Social Security; other public systems, including the federal government; and private sector plans.

Significant Findings:

- Social Security is increasing normal retirement age to 67. The federal government has adopted a general policy of encouraging employees to stay in the workforce.

- Federal government adopted a new plan in 1986 (FERS). It included a combination defined benefit, defined contribution and Social Security with a minor increase in normal retirement age. One of the main purposes for the change was to increase the portability of benefits for those leaving service prior to retirement.

- Current Plans II have higher normal retirement ages than most other public plans.

- There is no clear trend in the retirement age polices of other public plans. Some states are lowering and some are raising their normal retirement ages.

- A growing number of states are adopting defined contribution plans or combination defined benefit/defined contribution plans.

- TIAA/CREF, the largest private retirement system in the U.S. covering primarily colleges and universities is a defined contribution plan.

- Private sector plans are about equally divided between normal retirement at 65 and normal retirement between 62 and 65. Most of the largest U.S. companies provide for normal retirement at age 62, and many at age 60.

- Most of the largest U.S. company plans subsidize early retirement by using early retirement reduction factors between 3% - 6%.

- Generally only large or medium size firms provide any retirement plan. The most common plan design includes a combination of a defined benefit and defined contribution plans.

6 Employee Concerns - Analysis

Career Expectations and Career Plans

Most employers would agree that a long-term employee who works until the end of their working career and is ready to leave the workforce, should be able to leave without a substantial reduction in their standard of living. This in part protects employers from having to deal with unsatisfactory older workers.

Paternalistic benefit designs accomplish the goal of caring adequately for employees in retirement. However, when applying paternalistic designs to employees whose careers demand that they leave career employment at early ages, there can be considerable difficulty in achieving the paternalistic goal at a reasonable cost.

The issue of what benefit should be provided to those who leave covered employment earlier than when they leave the workforce is central to the retirement age question.

Traditional "Career Plans": TRS and LEOFF

Teachers, law enforcement officers, and fire fighters have developed career expectations, which generally include the assumption that they should be eligible for a lifelong "retirement" pension well before they reach an age when they would be expected to permanently leave the workforce.

There are many jobs that public employees perform that require physical capabilities that are reduced by the aging process, or that involve stressful conditions that may be more difficult to deal with at any age. In most cases employees plan on changing jobs prior to becoming "disabled" from carrying out the duties of their current job, and prior to permanently leaving the workforce.

However, in the case of public safety employees, teachers, and certain public employees, retirement systems have traditionally been designed to provide a source of income at an age when the employees were expected to end their work in those occupations. These traditional career plans have in the past been justified on the theory that it was in the public's best interest to have relatively young and energetic persons in these positions. That goal could be accomplished simply by firing employees when they could no longer carry out their duties. However, it is often suggested that employees who try to change occupations late in their working lives face great challenges, and therefore, the only reasonable way to motivate older employees to leave these jobs is through the payment of a "retirement" benefit. "Workers leaving career jobs typically incur substantial reductions in pay."[7]

Largely as a result of the existence of these career retirement plans, many teachers and public safety employees have the expectation that they should not have to change occupations if they find themselves no longer able to continue in their chosen occupation. The widely prevailing career expectation is that once they are "occupationally disabled," i.e., unable to carry out the duties of their current occupation, they should be able to collect a lifelong pension .

Public Employees in Other Occupations

Not surprisingly public employees in many other occupations also believe they should be able to receive a lifelong income when they are "disabled" from carrying out their current occupation. Each state is different in how it decides which public employees (occupations) should qualify for special benefits versus which employees should expect to change occupations and collect retirement benefits only at a later age.

Other States; Private Sector; Social Security

Most public employers provide special plans for teachers and public safety employees. However, permitting retirement at earlier ages for certain job classes is not common in the private sector. Employees in physically demanding jobs generally expect to have to move to less demanding jobs well before retirement. For example, Professor Dolittle, University of Washington School of Environmental Health, indicated that utility poll climbers typically change duties by age 35.

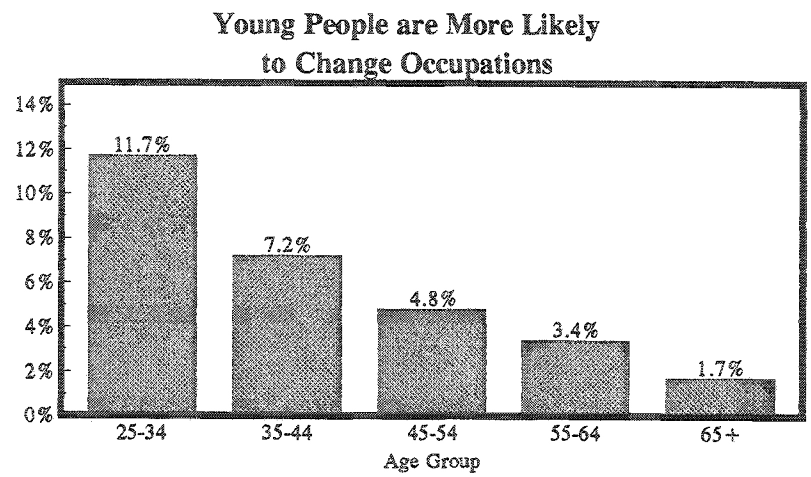
"Nearly 6 in 10 workers leave career employment before age 60...These early departures imply that career jobs are not synonymous with lifetime employment. Instead, almost two-thirds of workers remain in the labor force following the end of their longest held jobs, and more than one-third continue to work for 10 years or more."[8] (See Appendix L)

---

[7] The Work and Retirement Patterns of Older Americans, Employee Benefits Research Institute (EBRI), December 1991. Page 15

[8] Ibid., Page 11

Figure 6-1



Source: "The Education, Training and Work Experience of the Adult Labor Force from 1984 to 1995," National Commission for Employment Policy, June 1985

In addition the Social Security program makes no distinctions between careers: all employees become eligible for benefits at the same age, regardless of their occupation. Most employees who leave their "career" employment prior to age 62 remain in the workforce, in "bridging" employment until at least age 62.

Inability to Perform Job Due to Physical Limitations, or Due to Stress, Burnout, or Boredom

Physical Limitations/Disability

The aging process may lead to deterioration in physical strength, flexibility and reflexes which in turn may leave an employee unable to carry out the duties of the current job, but still able to carry out duties of other jobs. Employees in most occupations are expected to prepare for this eventuality and, if necessary, to make a "career transition" when it happens. Public safety employees, in contrast, generally expect that they should be able to "retire," and not be expected to move to a different job, when they reach a point of no longer being able to continue in their initial career.

This expectation tends to be common even among employees who plan to have subsequent employment after "retiring" from their public safety career. As noted above, the EBRI reports that most persons who "retire" early return to employment in some capacity. This is especially likely to be true for persons who "retire" in their late 40s or early 50s.

Professor Dolittle says "Fire fighters should have a career of ten to fifteen years and then move on to another career. For most fire fighters this transition would take place at about age forty... Society needs to prepare them for short careers." A fire chief of a major fire department in Washington state says: "Upon entry, new fire fighters should be counseled not to expect to spend a life-time in the fire service and they should be encouraged to prepare themselves for something else."

No "Magic Age"

Academic research indicates there is no objective data which points to a "magic age" at which persons uniformly or predictably become unable to carry out the duties of any given occupation. This research includes a 1991 study commissioned by the Equal Employment Opportunity Commission (EEOC), Research on the Use of Fitness Tests for Police and Fire Fighting Jobs.

The EEOC research is consistent with the findings of a 1977 GAO report, Early Retirement Policy for Federal Law Enforcement and Fire Fighter Personnel Needs Reevaluation:

"1) An abundance of scientific evidence exists showing that chronological age is a poor indicator of ability to perform a job. Physical abilities normally decline with age, but the rate of decline differs among individuals. Physiologists have demonstrated that other factors, such as aerobic and muscular fitness and amount of body fat, are more important in predicting poor performance than is age. Retirement policies that disregard differences in physical abilities and productive capacity are costly and wasteful.

"2) Many of the occupations covered by the [federal] special early retirement provisions do not involve extraordinary vigor.

"3) Additional compensation for hazardous duty ought to be reflected in pay, not retirement benefits.

"4) Those who are physically unable to work should be retired according to acceptable disability practices."

The report The Myths and Realities of Age Limits for Law Enforcement and Fire Fighting Personnel by the U.S. House Select Committee on Aging (December 1984) came to similar conclusions:

"There are three assumptions that underlie the conclusion that [early retirement] is necessary to ensure physically fit public safety departments: (1) abilities decline with age; (2) all, or nearly all, workers over a given age have the same abilities; and (3) individual abilities cannot be assessed.

"...Abilities associated with job performance do not invariably decline with age.

As workers age, there is greater variation in their abilities, and in some cases there is an improvement of certain skills and abilities with the added experience that comes with age. Research has shown that many physically fit older employees have much better health and fitness profiles than out-of-shape younger employees.

"...There are accurate and economical ways to test physical fitness and predict levels of performance for public safety occupations."

If a process of determining performance were in place, what is the appropriate benefit for a person who is occupationally disabled but not disabled from other work?

Stress, Burnout, Boredom

Public employees provide a wide variety of services in a wide variety of settings. It is clear that many find their work to be stressful, and that teachers especially are experiencing high levels of job stress. Figure 6-2 and 6-3 show the results of our retiree and active employee surveys. TRS I retirees listed job-related stress as *the most* important factor motivating the timing of their retirement. The results of the active member survey were even more stark:

Figure 6-2

Survey of Plan I Retirees
Importance of Stress in Decision to Retire

	PERS I	TRS I
Very Important	33%	46%
Not Important	40%	14%
Other	27%	40%

Figure 6-3

Survey of Plan I Actives
Anticipated Importance of Stress in Decision to Retire

	PERS I	TRS I
Very Important	25%	62%
Somewhat Important	54%	32%
Not Important	21%	6%

A 1991 study by Northwestern National Life Insurance Company, "Employee Burnout: America's Newest Epidemic," suggests that employees in all industries and across the country are experiencing more stress in their lives. In 1985, 13 percent of those surveyed believed stress had a major affect on their health, and 20 percent believed they were highly stressed. In 1991 these responses increased to 25 percent and 46 percent, respectively.

However, just as physical capabilities are not affected uniformly by the aging process, employees do not react uniformly to job stresses, or to spending long periods of time in the same occupation. Research such as the above study and interviews with employers suggest that stress is not a function of age or length of service. Instead it is related to a wide range of factors - employee personalities, workplace conditions, work hours, substance abuse, etc. Also, it is impossible to determine which employees "can't" continue service in an occupation due to these factors versus which ones just "don't want to."

The 1991 NNLIC study outlines a range of human resource management techniques that employers can use to reduce the stress in their workplaces.

Career Transitions vs. "Golden Handcuffs"

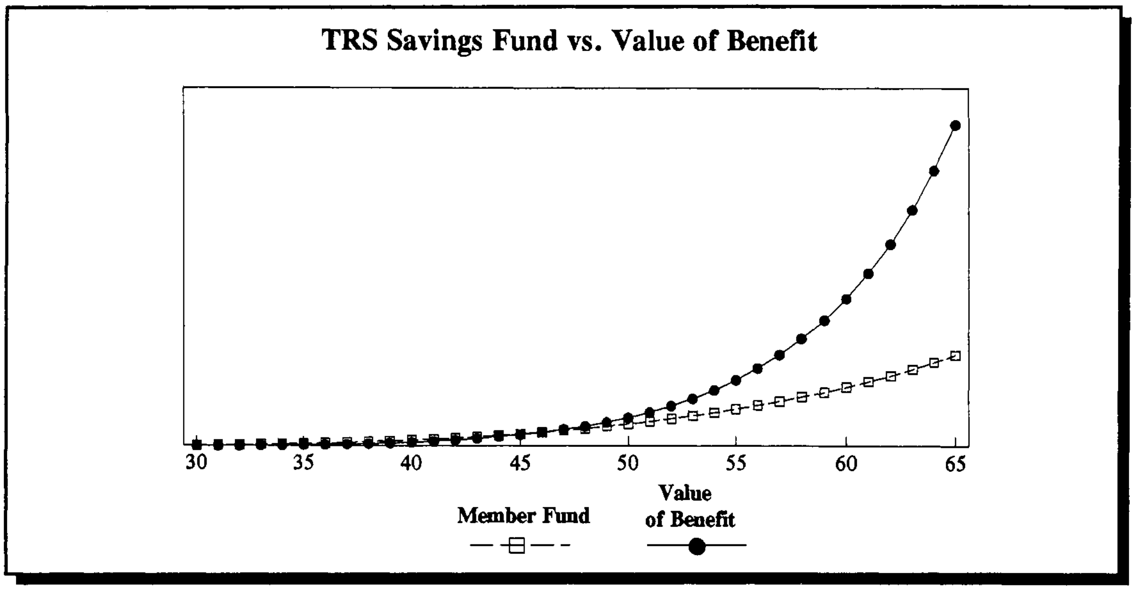
Plan II systems serve as "Golden Handcuffs"

The Plan II systems are classic defined benefit plans. They provide very little value (even negative value) for employees who leave service prior to normal retirement age, but provide very great value to employees who do stay until the normal retirement age. The employee who leaves early usually gets only a refund of contributions, with 5.5 percent interest. The employee does not receive the employer contributions made on his or her salary, nor any of the investment return earned over the 5.5 percent rate.

By way of contrast, the employee who stays until retirement "wins the lottery"; the value of his or her benefit at normal retirement age is much greater than the amount of his/her contributions. One of the reasons employers create defined benefit plans, in addition to the social contract policy discussed above, is to provide long-service, older employees a financial incentive to continue employment with the employer.

Plan I members in their 40s and 50s and Plan II members in their late 50s and early 60s have the greatest financial incentive to stay in jobs covered by the systems. Young Plan II members, in contrast, have little or no incentive to stay under covered employment; the value of their accrued benefit is usually less than the amount of their accumulated contributions. These points are illustrated by Figure 6-4.

Figure 6-4



"Golden Handcuffs" Discourage Career Transitions

Employees who want to make career transitions late in their working lives have to take a careful look at the potential impact on their retirement benefits. A Plan II member who moves to a new job covered by a private sector or different public sector retirement system has only two ways to collect a benefit for his or her Plan II service:

(1) Withdraw her/his member contributions in which case it will appear that the retirement system merely acted as a low yielding savings account; or

(2) Wait to collect a benefit at age 65, in which case the benefit received may have only a small fraction of the purchasing power it would have had at the time of the career change.

In either case the employee will usually receive a much smaller retirement benefit per year of service than if he or she had stayed in their current occupation until retirement.

The impact of "golden handcuffs" becomes stronger as employees get closer to being eligible for retirement; most older PERS II and TRS II members will have a very strong financial incentive NOT to make career transitions to private sector positions, and most older LEOFF II members will have a strong financial incentive NOT to move to a position covered by any other retirement system.

The most commonly sought way for members with significant service to obtain "value" from their retirement plan is to get the retirement age lowered so they can receive an immediate benefit on termination.

Portability - Providing Value for Prior Service

Benefits are portable if a member can maintain the value of the benefits earned for past employment when changing jobs prior to retirement.

The portability statutes for PERS, TRS and WSP provide a method to *retain value if a member leaves a covered system and goes to another one of the included systems.* Currently there is no portability or process to retain value if a member goes to a public system that is not included or to the private sector. Increasing the portability of benefits can overcome the "golden handcuffs" effect for those persons who elect to leave prior to retirement.

Summary

- Teachers and public safety officers have historically had career-based retirement systems. This has resulted in the expectation that they should have a lifelong benefit when they have completed a "career" in teaching or public safety without regard to their age or further employment plans. This pattern exists in most public systems.

- Such a pattern is not found in the private sector even in those areas which have high physical requirements or positions in which high levels of stress are encountered.

- Social Security makes no distinction between careers.

- There is no creditable data to show that there is any "magic" age at which persons are uniformly unable to perform the duties of any occupation.

- TRS I retirees listed job-related stress as the most important factor motivating the timing of their retirement. However, research and interviews with employers indicate that stress is not a function of age or length of service and is best dealt with through personnel management techniques.

- Broader portability provisions can reduce or eliminate the "golden handcuff" effect.

7 Employer Concerns - Analysis

More than 1000 local and state agencies employ Plan II members. This diverse group includes:

Figure 7-1

	PERS Plan II Membership
State Agencies and Institutions of Higher Education	45%
Counties	16%
Cities	10%
PUDs, Ports, etc.	5%
K-12 School Districts*	24%

* K-12 School Districts Employ more than 95% of all TRS II Members.

The counties, cities and fire districts also employ virtually all LEOFF II members.

These employers operate under a wide variety of pay and personnel systems, provide a variety of benefits, and find themselves in a range of financial situations. This diversity makes it difficult to generalize regarding their collective reactions to the Plan II systems.

Employers Generally Do Not Want Higher Costs

Pension Contribution Costs

Most of the Plan II employers interviewed did not desire changes in retirement benefits if the changes would require increases in pension contribution rates. An example of the high cost of employee benefits is illustrated in Figure 7-2.

Figure 7-2

1991-93 Biennium State-Paid Employee Benefit Costs in Dollars and by Percent of Pay

	PERS*		TRS		TOTAL	
(In Millions)	Dollars	Percent	Dollars	Percent	Dollars	Percent
State Pension	$436	7.33%	$490	12.23%	$926	9.30%
Health Care	614	10.31	367	9.18	982	9.85
Social Security - OASI	333	5.60	224	5.60	558	5.60
Social Security - DI	36	.60	24	.60	60	.60
Medicare	86	1.45	58	1.45	144	1.45
Totals	$1,505	25.29%	$1,163	29.06%	$2,670	26.80%

* Includes state and classified K-12 employees.

Demands for services continue to grow faster than revenues and increases in employee compensation force an unwelcome choice between hiring fewer employees (providing fewer services) or raising taxes.

Payroll Costs - Motivation for Early Retirement Proposals

Retirement systems can affect employer costs indirectly, as well as a directly. Public sector salary plans generally provide "seniority" increases rather than "merit" increases. This is most clearly seen in the K-12 salary plans where teachers automatically move up the salary scale with experience, regardless of their individual strengths or weaknesses.

These kinds of salary plans are usually combined with strong tenure or civil service provisions which may make it very difficult to get rid of unsatisfactory employees. *The combination of the salary plan structure plus tenure provisions provides a strong incentive for "early retirement" proposals in times of budget shortfalls.* The proposals are usually justified by proponents on the basis that the longer service, higher paid employees who retire can be replaced by less experience, lower paid employees, with little or no negative impact on public sector services. Some go so far as to argue that the younger employees will be more highly motivated and effective than the older employees they replace.

Concern about such indirect costs led to the adoption of an early retirement option for PERS I and TRS I in 1982 and 1992; these early retirees will be able to collect their pensions from 10 to 15 years earlier than they will be able to in PERS II and TRS II.

Plan I, with its significantly lower retirement ages than Plan II, has generated enough pressure from both employees and employers to cause the legislature to enact an even earlier retirement window twice in ten years. The propensity to follow suit in Plan II will be irresistible. The higher retirement ages in Plans II will mean a population distribution containing more older active members than would be the case under Plan I. Due to seniority-based pay increases, there will be more higher paid employees. *Higher Plan II costs for early retirees will result in higher contribution rates for active Plan II members as well as for employers.* Those who enjoy the benefit of early retirement will pay none of the cost; those actives who cannot retire early will pay for a benefit they cannot enjoy.

Encouraging Unsatisfactory Employees to Leave

Employers would like to be able to get rid of unsatisfactory employees. Employers are aware that the Plan II benefits discourage longer-service employees from making job changes, which can be a problem when the employee is not productive in his or her current job. Many of the Plan II employers surveyed specifically expressed an interest in reducing barriers and providing support for employees who feel stuck in their current positions and want to retrain for new careers. Many thought an expanded sabbatical benefit program would also be useful for employees needing a break from their jobs.

Employers generally pointed out that it is easier to encourage unsatisfactory employees to leave if making a job change that will not greatly reduce their retirement benefit; and that it is much easier to encourage them to retire than to fire them.

It is also easier for employees to make job changes if they have a source of income while they train for a new career, and if they have access to lateral promotions. Lateral hiring is, however, frequently restricted by public employee collective bargaining agreements and civil service provisions.

Retention of Productive Employees

Prior to Normal Retirement Age

Even as employers wish they could convince unsatisfactory employees to leave their organization, they also would like to retain good employees. However, most did not believe the retention quality of the Plan II "golden handcuffs" policy will come into play until employees are close to being eligible for retirement. Some employers did not seem to be advocates of such a design at all; those who pay competitive salaries and have good working conditions would not need the pension system to promote retention.

At Normal Retirement Age

After employees qualify for unreduced retirement under a defined benefit plan, they have a very strong financial motivation to begin collecting their benefits as soon as possible. Employees frequently feel "forced" to leave; that they are working for partial pay if they delay receipt of their benefits.

Employers Would Like to Recruit Good Employees

Local and state governments, like all employers, would like to be able to recruit a good, productive workforce. New employees tend to be young and mobile; retirement benefits are usually not a significant factor influencing the decision of whether to accept a job offer. However, high employee pension contribution rates could be a detriment to recruiting, especially for employers whose salaries are not especially competitive. Most employees choose a job based on immediate benefits and take-home pay.

Employees in careers which routinely involve significant mobility (city managers, nurses and other medical professions, technical trades, etc.) might be more likely to accept a position with an employer offering a portable pension benefit. This was a prime motivation in offering TIAA/CREF to higher education employees.

Summary

- Employers do not want higher pension costs.
- There have been two early retirement bills for Plan I in ten years to eliminate higher-paid members. Clearly, the same factors will create even more pressure for an even more expensive early retirement window for Plans II.
- A "golden handcuffs" policy retains the unsatisfactory employee as much as, or more than, the productive employee.
- Steps taken to increase the portability of pension benefits and to support career transitions may result in a more satisfied and productive workforce, but also make it difficult to retain employees who could earn more from other employers.
- Retirement benefits do not have a significant effect on recruitment.

8 Disability Issues

Our survey of LEOFF II employees established that duty disability was the benefit area where employees had the greatest concern--even greater than the age 58 for normal retirement. Most LEOFF II members are many years from retirement and more interested in benefits that have an immediate affect on their livelihood.

When LEOFF II was created in 1977, the single greatest change in benefits was for disability. LEOFF II employees were placed under Industrial Insurance for duty disability coverage and coverage for off-duty disabilities was removed. The benefit paid from the LEOFF II plan for persons who are disabled is an equivalent of the retirement benefit that has been earned.

Following is an approximate breakdown of the costs of LEOFF I benefits that do not include any payment toward the unfunded liability.[9]

Figure 8-1

LEOFF I Costs

	Percentage of Pay
Service Retirement	15%
Disability	27%
Active death	1%
Other	1%
Total	44%

[9] These costs are those that would be incurred if a new plan were created for new hires with LEOFF I benefits. They do not include any effect of past under-funding, initial liabilities, etc.
There would be an additional cost of 8% of pay of all LEOFF members (or 86% of only LEOFF I members' pay) to pay Plan I unfunded liabilities.

Since 1977, most of the effort by members to make changes to LEOFF II have been to include duty disability benefits.

Clearly, disability benefits have the potential for significant cost and should be studied carefully. When considering disability, several issues need to be discussed:

- **Occupational Disability vs. Workforce (Total) Disability:** The level or extent of the condition.

- **Duty Disability vs. Non-Duty Disability:** The source or the situation that caused the condition.

- **Career Protection Benefit vs. Protection of Earning Power:** The amount of the benefit.

Occupational Disability vs. Total and Permanent Disability

Both of these are standards to be looked at when determining whether or not a person is disabled. They are at opposite ends of the spectrum of possible definitions of "disability."

Occupational disability would result from any condition that would keep someone from performing the duties of his/her immediate job. This benefit standard is much easier to reach and results in more employees qualifying for disability. Indeed a person may be *truly occupationally disabled and not appear to be disabled at all.* This standard is frequently extended to include stress/mental conditions associated with the job. As such, these conditions may completely vanish as soon as the person leaves her/his current job. The vast majority of people who are occupationally disabled would be able to find work for which they are not disabled. This is especially true for those in physically demanding or stressful employment.

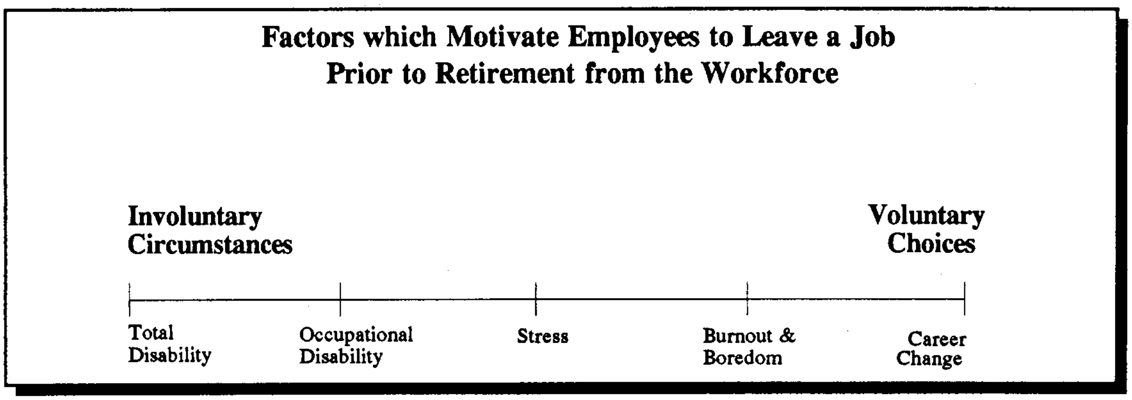
Total and permanent disability is the most stringent standard. It means a person is now disabled from any work and will likely remain so. This type of standard is used in granting Social Security disability benefits. It results in fewer disabilities because those who cannot perform their current occupation are expected to find other work they can perform.

Private insurance companies frequently write disability insurance as a combination of the two. Long-term disability benefits offered by the State Employees Benefits Board (SEBB) are payable for:

Two years during "complete inability of the member to engage in the member's regular occupation."

Thereafter, "total disability means complete inability of the member to engage in any employment or occupation for which the member is or becomes reasonably fitted by reason of education, training or experience."

Figure 8-2



Factors which Motivate Employees to Leave a Job Prior to Retirement from the Workforce

Industrial insurance provides permanent disability benefits for any condition(s) resulting from a covered injury or occupational disease permanently incapacitating the worker from performing any work at any gainful occupation, taking into account the worker's age, education, experience and unrelated impairment existing at the time of injury/disease.

Duty Disability vs. Non-Duty Disability

The question of the cause of the disability often determines whether or not there will be any compensation, the size of the benefit and whether or not it is taxable.

Duty disability, generally speaking, concerns those injuries which are related to work. However, there can be substantial differences of opinion in what is meant by "related to work."

The definition of "duty related" can be anything from a specific, tight definition relating only to accidents on the job to something as general as "any disability incurred in the line of duty" (LEOFF I). In LEOFF I, 78 percent of all disabilities are determined to be in the line of duty.

The state Industrial Insurance program is responsible for providing on the job disability benefits for almost all workers in the state. This includes all members of PERS, TRS, WSP and LEOFF II. LEOFF I members are exempted.

Industrial Insurance provides benefits when there is an injury on the job that is "a sudden and tangible happening, of a traumatic nature producing an immediate or prompt result." It also pays benefits for an occupational disease that is a "disease or infection that arises naturally and proximately out of employment." Claims based on mental conditions or stress do not fall within the definition of occupational disease.

There have been proposals that additional conditions and illnesses be included in the Industrial Insurance definition of "duty" disability for public safety workers. These include proposals to cover conditions such as heart and lung diseases, and other physical ailments that are prevalent in the general population. Other conditions such as stress and mental problems are also sometimes considered to be job related causes of disability.

LEOFF I duty disability benefits and Industrial Insurance benefits are both non-taxable.

Career Protection Benefit vs. Protection of Earning Power

The question here relates to when a benefit is to be payable and the size of the benefit to be provided.

A benefit providing career protection is one utilizing occupational disability standards for awarding benefits and providing the same benefit as if the career had continued to retirement. This type of benefit would generally be sufficient to live on throughout life.

A benefit to protect earning power would be payable to someone whose earning power has been diminished and to the extent that earning power has been diminished. People who are occupationally disabled are expected to find another occupation if they are able and receive disability compensation to the extent that their long-term earning power has decreased.

Industrial Insurance provides payments for disability based on the extent of the inability to perform work. A person who is partially disabled receives a benefit that is smaller than someone who is totally incapacitated for work. For a member who is totally disabled, Industrial Insurance benefits may exceed those provided for in LEOFF I.

LEOFF I provides for a benefit of 50 percent of pay fully increased each year by the CPI. This is the equivalent of the benefit that is paid to a member who retires after 25 years of service.

LEOFF I includes:

- Occupational disability coverage
- Duty defined very broadly
- Career protection benefit

Industrial Insurance includes:

- Workforce disability coverage

- Duty defined narrowly
- Protection of earning power

Many of the problems concerning disability in the LEOFF I system come from totally different expectations concerning the above three issues. The "abuses" of LEOFF I are more a reflection of a plan designed to provide occupational disability and career protection than of members cheating the system.

Even if the benefit in LEOFF I were limited to duty disability, as long as it is defined as anything that is job related, including stress, emotional conditions and physical conditions prevalent in the general population, there would be little reduction in the costs.

It is not just "abuses" which have caused the high cost in LEOFF I disability. It is that insuring someone's career is a very expensive task. That is completely different than insuring someone's capacity to earn a living against work related injuries.

In recognition of the physical nature of the work, most of these plans have retirement eligibility standards that allow retirement at very early ages--frequently from 45 to 55. Although these ages are young in relation to other types of plans, they are really nothing more than the extension of the occupation disability standard, i.e., when they can no longer perform the duties of the job, they are retired.

Having a high retirement age while keeping an occupational disability standard would not significantly increase the age at which people retire.

Further, lowering the normal retirement age does nothing for the individual who becomes occupationally disabled at 30-40. One of two things will occur: (1) pressure to lower the normal retirement age further; or (2) pressure to adopt a liberal disability program which will render normal retirement age meaningless as it essentially is in LEOFF I.

Summary

All surveys indicate that the most immediate concern of LEOFF II members is coverage for duty disability. Three important concepts need to be resolved in this area:

- Occupational versus Total and Permanent Disability - A person may be disabled to such an extent they cannot perform a specific job but could perform many other jobs.

- Duty versus Non-Duty - No unanimity of opinion of definition.

- Career versus Earning Power Protection - Career approach treats disabled individuals as though they had completed their careers and pay a full pension. Earning power approach pays for the earning capacity lost and expects the individual to earn the balance in another occupation.

9 "Social Contract" vs. "Deferred Compensation" Policies

Social Contract Approach (Retiree Preference)

One way of looking at pension benefits is to assume that after an employee has provided a long period of service and reached a certain age, the employer owes him or her a pension that will provide financial security for the remainder of the retiree's life. *Under this theory, once a long-service employee reaches an age where he or she can't be expected to continue in the workforce, the employer has a moral obligation to provide an adequate retirement benefit.* The employer's responsibility is considered unconditional: regardless of what happens in the economy, etc. the employer is responsible for assuring the retiree's financial security for the remainder of the retiree's life, and perhaps for the remainder of her or his beneficiary's life.

The Social Security system reflects, in large part, this view of pensions through its mandatory coverage requirements, full COLA, and requirement that benefits be paid only in the form of a monthly allowance for life. However, when the early pension systems and Social Security were first created, they provided a very modest level of benefits and it was expected that retirees desiring to maintain their pre-retirement level of consumption should rely on personal savings and private pensions to provide much of their retirement income.

Over time, expectations have been raised. Public employees now often expect to be able to maintain their pre-retirement standard of living which is usually higher than they enjoyed through most of their working life. For example, the Plan II pension formula and Social Security benefits combined can replace more than 100 percent of an employee's final compensation for long-service employees.

Employee organizations generally take the position that employees should not have to rely on personal savings to achieve their desired standard of living in retirement. Ten of 13 organizations indicated "A career employee should not be responsible for adding any amount of income to their retirement other than the contributions they have made to their Plan II benefit and Social Security."

As medical costs have increased dramatically, and employer paid health insurance has become a common employee benefit, the expectation has also arisen that the employer ought to pay for, or at least subsidize, post-retirement medical insurance in addition to providing a pension. For short-term employees, the value of post-retirement medical benefits can be greater than the value of their pensions.

Paternalism: A Reflection of the "Social Contract"

Adoption of a social contract approach to pension policy naturally leads to a paternalistic plan design. The employer is expected to provide retirement benefits to fulfill a specific obligation (to provide lifelong financial security). It follows that the retirement plan should only pay benefits in a form, and at a time, that carries out that obligation, regardless of what other options employees or retirees might prefer. *It is impossible to carry out the "contract" if employees are given options that significantly alter the way benefits are paid.*

Defined benefit retirement plans are best suited for meeting the goals of the social contract approach. The plan takes on the risks of poor investment return, pre-retirement inflation, unanticipated salary increases that drive up the cost of benefits, changes in life expectancies, etc.

These plans are usually designed for those employees who retire from the system. Employees who terminate prior to retirement fall outside the contract.

Clearly, retirees prefer this approach. They feel the benefit is there to satisfy a purpose and the employer is responsible for continuing to satisfy that purpose under changing circumstances.

Plan II Benefits Reflect "Social Contract" Approach

The "social contract" is seldom if ever carried out entirely with blanket guarantees. It is usually reflected in the general design of the system and in the allocation of resources in the plan design.

The Plan II systems reflect a "social contract" approach. Their defined benefit formulas provide a generous, secure benefit which is payable at an age when employees are expected to permanently leave the workforce, and which includes an automatic COLA.

The Plan II benefits also reflect a paternalistic design. Membership is mandatory, and retirees must receive their benefit in the form of a monthly benefit, payable for life.

While some retirees would prefer to have more flexibility in determining the form of their benefit payout, the social contract approach tends to be popular with most retirees since it provides a high degree of financial security. On the other hand the social contract approach is not greatly appreciated by active employees who are mandated into the systems and receive relatively little value until they near retirement.

Deferred Compensation Approach (Active Employee Preference)

A competing theory of pension benefits, popular with many active employees and employee organizations, is that retirement benefits are merely a form of deferred compensation. *Under this theory, the compensation that is set aside by the employer as a "retirement" benefit should be paid at a time, and in a form, desired by employees.* Their payment fulfills all employer responsibilities. Although the payments are called "retirement" benefits under this policy approach, they are treated more like a form of "severance" payments; the compensation is made available when employees separate from employment at any age, as opposed to being paid only when the employee is expected to leave the workforce.

This approach to pension benefits is commonly associated with defined contribution plans where the employer commitment is defined in terms of the amount of compensation that is to be deferred for later receipt. Elements of the deferred compensation approach may be included in defined benefit plans in the form of cash-out options, early retirement, benefits without COLAs, etc.

The deferred compensation approach is often popular with active employees who want greater flexibility in the form and/or timing of their "retirement" benefits or who do not stay until retirement and want to receive value for their service.

However, an implication of this philosophy, often not recognized or popular with retirees, is that the employer's obligation is presumably limited. If the employer's commitment is to defer a certain amount of income, the implication is that the retiree may take on additional risks such as: poor investment returns, high inflation, outliving one's savings, etc. The higher education retirement plan (TIAA/CREF) is an example of the deferred compensation approach.

Legal Environment

The legal environment causes the "social contract" design to be difficult to carry out without substantial risk of increased costs. The legislature has very limited ability to adjust benefits over time to carry out any specific purpose, or react to any changes in Social Security, tax policy, compensation, etc. The courts generally view any benefit under a strict deferred compensation theory when it is to the advantage of the employee.

From the time a member joins the system (contact created) until they die as a retiree may be 60-70 years. Certainly no plan can be created that will anticipate all the members/retirees needs over that period of time. Needs change with the economy, retiree and employee expectation, other state and federal programs, etc. In the last 25 years we have seen both an increased value of Social Security, Medicare and an emphasis on retiree medical. Under a "social contract" theory, benefits should be adjusted to where they are most needed. However, the courts won't allow this. They view the plan as a "contract" of deferred compensation.

Summary

This chapter deals with the issue of social contract versus deferred compensation policies.

Social contract means that after a period of long service and reaching a prescribed age, an employee is entitled to a life time benefit protected against inflation sufficient in amount to maintain the pre-retirement standard of living. This policy is preferred by those who qualify for retirement. Paternalistic plan design implies little flexibility in how benefits are paid. Plan II systems reflect such a policy.

Deferred compensation means the employer holds out some sum of money from an employee's pay and pays it plus its earnings at some date in the future. Active employees who do not expect to reach qualification for retirement prefer such a policy. Implies a flexible plan design which gives employees choices in when they receive benefits. Defined contribution plans such as FERS Thrift Savings Plan and TIAA/CREF tend to reflect such a policy.

It is very difficult to allow substantial employee flexibility in the timing and form of their benefit and carry out the social contract. Members who begin to receive their benefits at very early ages may have benefits that will be inadequate when paid out over a long period of retirement. Retirees who withdraw part of their benefit in cash at retirement also make it difficult for a plan to provide for the adequate benefit. For these reasons, *paternalistic plan designs usually have later retirement ages and fewer options.*

10 Evaluation Criteria

The following criteria for evaluating possible changes in pension policy direction were developed from the JCPP October 1990 Study Outline. In Chapter 11 five possible approaches for changing the Plan II systems are evaluated in terms of how they respond to each of the following concerns and the Plan II policy elements.

Employee Concerns

Concerns of Those in Career Employment

Public safety employees, teachers, and some public employees often feel they "deserve" a lifelong pension when they leave their career job.

General Dissatisfaction With Plan II Benefit Design

- Plan II members do not get "reasonable value" if they want to leave or have to leave (occupational disability) prior to normal retirement age.
- Plan II members do not receive a fair (market rate) return on their contributions.
- Plan II members have little choice in the timing or form of their payment.
- Some Plan II benefit features, such as early retirement reduction factors, appear punitive.
- Members would like more paid leisure time.

Employer Concerns

- The primary concern mentioned by most employers was that they were not looking to increase their pension costs.

- Employers would like to retain their *productive* employees.
- Employers would like to motivate and assist *unsatisfactory* employees to move on to other jobs.

Plan II Policies

- Retirement benefits are only paid at an age when employees are generally presumed to permanently leave the workforce.
- The Plans provide an adequate initial benefit at retirement for a long-service member.
- The benefit will be annually adjusted to assist in retaining the original purchasing power of the benefit.
- All public employees receive identical, or at least very similar, benefits to reduce "leapfrogging" pressures.
- The contribution rate is shared equally by the employer and employee, as a way to reduce constant pressure for benefit enhancements.
- The retiree's benefit is secure - not dependent on the economy or financial markets, nor on the judgement of the retiree.
- To ensure the benefit is used for retirement, the member is given few options in how it is received.
- Disability and death benefits are insurance concerns and not part of a retirement system.

Summary

This chapter enumerates the specific employee and employer concerns and restates the policies adopted by the legislature in 1977. Proposed changes in Plans II will be measured in terms of how well they satisfy these concerns and policies in Chapter 11.

11 Possible Approaches for Change

Washington stands at a crossroad. The choice to be made is whether it should continue on the road of its present retirement policy or, instead, take a new path instituting a change in policy direction. A pivotal issue in the decision is when members should begin to receive a retirement benefit.

Overview of Five Approaches

The Plan II Retirement Age Study Outline directed staff to identify and develop approaches to resolving employee and employer concerns. It is clear that no single approach could resolve all the concerns identified in Chapters 3 and 4. In many cases the various parties have conflicting goals. For example, adoption of a "career" retirement approach, best represented by the LEOFF I plan design, is inconsistent with the employer desire to avoid substantial increases in pension costs. Likewise, adoption of a defined contribution plan to provide greater employee flexibility would clash with the "social contract" goal of ensuring financial security for the duration of retirement.

Five possible approaches to modifying the Plan II systems are discussed in this chapter. These approaches represent a wide range of policy and benefit design options available for responding to employee concerns.

The five approaches fall into two broad groups:

- Three which would generally continue the benefit design of the current Plan II benefits; and

- Two which would replace the current Plan II systems with new plans having a significantly different design.

In most cases the approaches can be combined with each other, or otherwise modified, depending on the state's policy objectives and cost limitations.

Summary of Approaches

Generally Continue Current Plan II Design

- Reduce the Plan II normal retirement ages and/or the Plan II reduction factors for early retirement.

- Makes changes to the Plan II systems to increase the value of the benefits received by employees who leave a Plan II system prior to retirement. Provide additional ways for members to get part of their benefits paid at an earlier age, in exchange for reduced benefits after the normal retirement age.

- Provide individual employees with choice of plans with different retirement ages.

Replace the Current Plan II Systems

- Replace the Plan II systems with a combination defined benefit - defined contribution plan. This design closely resembles the typical private sector retirement plan, and the new Federal Employees Retirement System (FERS).

- Replace the Plan II systems with a new defined contribution plan.

Approach 1(A): Lower the Normal Retirement Ages for the Plan II Systems to Plan I Retirement Ages.

Approach 1(B): Significantly Reduce the Early Retirement Reduction Factor for Calculating Early Retirement Benefits.

Brief Description/Purpose

Approaches 1(A) and 1(B) include two closely related options. Under both, all other Plan II provisions would remain unchanged.

Approach 1(A) would reduce Plan II retirement ages to those in Plan I: Age 50 with 5 years in LEOFF; and age 60 with 5 years, age 55 with 25 years, or any age with 30 years in TRS and PERS. This approach reflects the most common employee organization proposals since 1977. A variation is also reflected in the most common proposals from the employee organization surveys:

normal retirement after 20 years in PERS II; and after age 50 or 20 years in LEOFF II. *While this would lower the retirement age it would not provide any greater value to those who want to or must leave prior to qualifying for retirement.*

Approach 1(B) reflects a proposal made by several employee organizations in the 1992 Legislative Session - keep the current Plan II normal retirement ages, but lower the early retirement adjustment factors from a full actuarial adjustment (about 7 - 9 percent per year) to 1 percent per year. This is a way to provide greater value for those who leave prior to normal retirement.

Cost: Additional employee and employer contributions required. (See Chapters 12 and 13)

Approach 2: ***Maintain Current Plan II Benefit Design, with Changes to Increase Career Mobility and to Allow Limited Payments Prior to Normal Retirement.***

Under this approach certain enhancements would be made to the current Plan II benefits. The goal of these changes is to make it easier for employees to transition to new careers, and to provide ways for members to be paid their accumulated contributions prior to normal retirement age, or at retirement, in exchange for a reduced permanent retirement allowance.

Six possible changes are discussed separately below.

(1) Optional Job/Retirement Transition Benefit

Brief Description/Purpose

A new benefit option would permit long-service employees to be paid a monthly income from their accumulated contributions under two circumstances:

- For up to two years while training for a new career or on a sabbatical break (job transition benefit); or
- When leaving the work force between age 60 and 65 (retirement transition benefit).

The member would receive a reduced benefit at retirement to reflect the member contributions paid out before normal retirement age. The reduced benefit could be actuarially equivalent or could be partially subsidized.

The Job Transition Benefit would provide long-service members with a means to support themselves for up to two years while they get training or additional education for a new career or to provide paid sabbatical leave. Members would not be required to return to covered employment. It would make it feasible for employees to plan for career transitions in early stages of their initial careers.

The Retirement Transition Benefit would provide long-term employees with a source of income to "bridge" the period between age 60 and when the retiree applies for retirement and Social Security.

Cost: No cost if on an actuarial equivalent basis. Could be subsidized by the plan.

(2) Automatic Increase for Vested Benefits

Brief Description/Purpose

Upon separation, Plan II members who leave their contributions with the system (also known as terminated, vested members) would have their benefit increased each year during the period between when they terminate and when they retire by the change in the CPI, up to 3 percent per year. The member would not begin receiving the benefit until the normal retirement age.

Figure 11-1

	Age 65 Current Benefit	**Age 65 Indexed Benefit**
Employee with 20 years service, leaves service age 45, $40,000 AFC:	$16,000	$28,900

Indexing the *terminated vested benefit* would help ensure that long-service employees leaving work covered by a state retirement system would receive a benefit at normal retirement age that had increased in value to keep up with inflation. It would reduce the financial penalty incurred by employees who move to positions in the private sector, or other positions not covered by the state's portability chapter.

Cost: Additional employee and employer contributions required. (See Chapter 14)

(3) Expand Coverage of Current Portability Statute

Brief Description/Purpose

The coverage of Chapter 41.54 RCW which creates a portability benefit for members of PERS I, PERS II, TRS I, TRS II, and the WSPRS would be amended to include LEOFF II, and the Seattle, Tacoma, and Spokane retirement systems.

This expansion of the current portability statutes would remove a current barrier to career transitions from jobs covered by LEOFF to jobs covered by PERS, or by the Seattle, Tacoma or Spokane systems.

Cost: Additional employee and employer contributions required. (See Chapter 14)

(4) Optional "Phased Retirement" Benefit

Brief Description/Purpose

A new benefit option would permit PERS II and TRS II members to work half-time and at the same time collect 50 percent of their accrued retirement allowance, for up to 3 years prior to full retirement. At full retirement the member's benefit would be calculated using a full-time salary.

This would provide a limited option for persons who felt they did not want to, or could not, continue in full-time employment until age 65, but could continue in a part-time position.

Cost: No cost if on an actuarial equivalent basis.
Could be subsidized by the plan.

(5) "Market Rate" Interest on Member Contributions.

Brief Description/Purpose

Member contributions would be credited with interest at a rate which more closely reflects market rate interest. This responds to the most frequent complaint of members and provides additional value to those leaving prior to retirement.

Cost: Additional employee and employer contributions required. (See Chapter 14)

(6) Withdrawal of Accumulated Contributions at Retirement

Brief Description/Purpose

A new benefit option would allow members to withdraw their contributions, plus interest, at retirement, as permitted in TRS I. This provides members with additional flexibility.

Cost: No cost if on an actuarial equivalent basis.

Approach 3: Allow Employees to Choose Between Three Different Retirement Plans, Each with Benefits Similar to Current Plan II Systems, Except for Different Normal Retirement Ages.

Brief Description/Purpose

Under this approach the state would create three new retirement plans with benefit provisions similar to PERS II, except that each retirement plan would have a different normal retirement age: age 65 (Tier 3A), age 60 (Tier 3B), and age 55 (Tier 3C).

Employees would have the option of selecting which plan they wished to be covered under, but would pay higher contribution rates for service earned under the plans with the earlier retirement ages (Tiers 3B and 3C). Benefits would be portable, i.e., the salary earned while participating in one of the three plans could be used to calculate benefits in the other two plans. Employees could be given options to move between the different plans. This will allow employees who place a high value on earlier retirement to select the plan which best meets their goal and pay accordingly.

Cost: Could require significant increases in employer contribution rates. (See Chapter 15)

Approaches which Replace the Current Plan II Systems:

The current Plan II systems are traditional defined benefit systems. They have a paternalistic benefit design (little flexibility in the timing and form of benefits) and provide great value to employees who stay until normal retirement age, but little value to employees who leave early. Due to the constraints imposed by the courts in the Bakenhus line of cases, it appears that the only way a major change in benefit design could be implemented would be through the creation of a new retirement plan, applicable only to new hires and current Plan II members who elect to transfer to it.

Approach 4: Replace Current Plan II Systems/Benefits with new "Split Plans" Which Reflect Typical Private Sector and New Federal Employees Retirement System (FERS) Plan Design.

Brief Description/Purpose

A new retirement system would be created to include both an employer-paid defined benefit pension and an employer- and employee-funded defined contribution account.

Employer-funded basic defined benefit plan:

Under this approach the employer would provide a "basic" retirement pension, payable when the employee is expected to permanently leave the workforce, which would provide a basic level of financial security when combined with Social Security benefits. Most provisions of the basic pension would be identical to current Plan II provisions, EXCEPT: (1) The plan would be noncontributory (100 percent employer-paid); (2) the benefit would be based on a 1 percent formula; (3) the benefit would "vest" after 10 years of service, and (4) terminated, vested benefits would receive annual increases such as discussed in Approach 2.

Employee- and employer-funded defined contribution plan:

This approach would also include a mandatory defined contribution account. Employees would contribute 6 percent of compensation, a level roughly equal to an average of the current plan II employee contribution rates.

The account would be payable to the member upon disability, death, or permanent separation from employment. The account would be payable in the form of a regular or variable annuity, a bridge payment to age 58 or 65, rollover to IRA, or lump sum.

In addition, local employers could be permitted to contribute an additional amount for LEOFF employees to pre-fund "retirement bridge" benefits.

Cost: Employer costs could be similar to current Plan II or higher depending on the size of the defined benefit portion and any employers participation in the defined contribution portion.

Approach 5: Replace Plan II Systems with Defined Contribution Plan

Brief Description/Purpose

Replace the Plan II systems with a defined contribution retirement plan closely modeled after the TIAA/CREF plan for higher education faculty. Contribution rates would closely match current contribution rates.

Benefits could be made payable at separation from service, disability, or death. Benefits could be made payable in variety of forms: regular or variable annuity, annuity for a fixed period, rollover to IRA, or lump sum. Spousal consent could be required for payments that do not include a survivor benefit.

Such a plan design would provide a source of savings dedicated to retirement income which would be highly portable for employees who switch jobs prior to normal retirement.

Cost: Determined by the contribution rate.

The following matrix evaluates how each approach satisfies concerns and follows the 1977 policies. Since concerns of interested parties and the policy elements are not identical and frequently in direct opposition, no approach satisfies all criteria.

Responsiveness of Approaches to Evaluation Criteria

Legend:

I(A)-Plan I Normal Retirement Age

I(B)-Reduced Early Retirement Factors

II-Plan II with more options

III-Plan II with optional retirement ages

IV-Split DB/DC Plans

V-Defined Contribution Plan

	Possible Approaches for Change					
Evaluation Criteria	I(A)	I(B)	II	III	IV	V
		Y = Yes	N = No	? = Maybe		
Respond to Employee Desire for:						
• Meet concerns of "Career Employees" (Retirement After Fixed Career)	Y	N	N	Y	N	?
• Reasonable Value if They Leave Prior to Retirement.	N	?	Y	N	Y	Y
• Greater Flexibility in Form and/or Timing of Benefits.	N	?	Y	?	Y	Y
Respond to Employer Desire for:						
• Low Pension Costs.	N	N	Y	?	Y	Y
• Retention of Productive Employees.						
Before normal retirement age.	Y	?	?	Y	N	N
After normal retirement age.	N	N	N	N	Y	Y
• Assisting Employees in Making Job Transitions.	N	N	Y	N	Y	Y
Continue Plan II Policies:						
• "Secure" Benefit.	Y	Y	?	Y	?	N
• Contribution Sharing/Similar Benefits.	Y	Y	Y	Y	?	Y
• Payable When Permanently Leave Workforce.	N	N	Y	?	?	?

Summary

The five approaches for change are presented in two groups: three which maintain basic Plan II design with varying degrees of modification; and two which require new Plans III.

Plans which remain basically Plan II:

- Lower normal retirement age and/or reduce early retirement reduction factors.
- Increase career mobility and allow limited payments prior to normal retirement.
- Allow employee choice of retirement normal age with employee contribution reflecting cost of plan elected.

Plans III:

- Combination defined benefit and defined contribution plan.
- Defined contribution plan.

12 Approach 1(A)

Lower the Normal Retirement Ages for the Plan II Systems to Plan I Retirement Ages.

Description

Reduce the Plan II normal retirement ages to the current Plan I provisions:

LEOFF II	Age 50 with 5 years of service
PERS II/TRS II	Age 60 with 5 years; age 55 with 25 years; or any age with 30 years of service

Purpose

This approach would make benefits available to members after they have provided 20 to 30 years of service, i.e., "service based" or "career based" retirement. It would allow members to spend a longer period of time in "retirement" by paying benefits prior to when the employees would be expected to permanently leave the workforce.

Advantages

(1) Responds to employee organizations' desire for service or career based retirement.
(2) Responds to employees' desire for longer period of retirement.
(3) Provisions would be as generous, or more generous, than most other state retirement systems and most local LEOFF systems.

Disadvantages

(1) Does not provide reasonable value for employees who change jobs prior to normal retirement due to career change or occupational disability.
(2) Does not provide significant additional flexibility.
(3) High Cost.

(4) Additional pressure for COLAs and post-retirement medical benefits.

Costs

Figure 12-1

Early Retirement Proposals - Plan I Retirement Age

(In Millions)	PERS	TRS	LEOFF	TOTAL
State & K-12 Biennial Cost 1993-95	$143	$91	$9	$242
Increase in State Rate	2.84%	3.84%	1.10%	
Local Government Cost 1993-95*	$72	---	$13	$85
Increase in Local Employer Rate	2.84%	---	1.65%	
Average increase in Annual Member Cost 1993 (dollars)	$825	$1,305	$1,181	
Increase in Member Rate	2.84%	3.84%	2.75%	

* If the State's share of the increased cost in LEOFF II were paid by the local employers, their total rate increase would be 2.75% and the total cost increase would be $22 million for 1993-95.

Possible Variation

Lower normal retirement age 3 to 5 years - Age 62 or 60 for PERS II and TRS II; age 55 or 53 for LEOFF II. (See Appendix L for Cost Data)

For PERS II and TRS II, this change could reflect a new assumption regarding the age at which employees are expected to permanently leave the workforce. For LEOFF II, this change would result in eligibility criteria more comparable to typical local LEOFF systems in other states.

The major advantage of this approach is that the new PERS II and TRS II retirement ages would be more consistent with the most common retirement eligibility provisions found in other public and private sector retirement systems. Employees would also be able to enjoy 3 to 5 more years in retirement.

The major disadvantages, besides the immediate cost, would be the lack of value provided to employees who leave prior to normal retirement, and the lack of flexibility. Also, it could be expected there would be continuing pressure to make additional reductions.

Figure 12-2

Early Retirement Proposals - 3 Year Age Reduction

(In Millions)	PERS	TRS	LEOFF	TOTAL
Retirement Age 62 (55 LEOFF)				
State & K-12 Biennial Cost 1993-95	$66	$46	$4	$116
Increase in State Rate	1.32%	1.94%	.49%	
Local Government Cost 1993-95*	$33	---	$6	$39
Increase in Local Employer Rate	1.32%	---	.73%	
Average Increase in Annual Member Cost 1993 (dollars)	$382	$660	$525	
Increase in Member Rate	1.32%	1.94%	1.22%	

* If the State's share of the increased cost in LEOFF II were paid by the local employers, their total rate increase would be 1.22% and the total cost increase would be $10 million for 1993-95.

Figure 12-3

Early Retirement Proposals - 5 Year Age Reduction

(In Millions)	PERS	TRS	LEOFF	TOTAL
Retirement Age 60 (53 LEOFF)				
State & K-12 Biennial Cost 1993-95	$89	$58	$7	$154
Increase in State Rate	1.78%	2.45%	.82%	
Local Government Cost 1993-95*	$45	---	$10	$55
Increase in Employer Rate	1.78%	---	1.23%	
Average Increase in Annual Member Cost 1993 (dollars)	$516	$832	$881	
Increase in Member Rate	1.78%	2.45%	2.05%	

* If the State's share of the increased cost in LEOFF II were paid by the local employers, their total rate increase would be 2.05% and the total cost increase would be $17 million for 1993-95.

In surveys conducted in 1991, Plan II members expressed a willingness to pay higher employee contribution rates in exchange for reductions in the Plan II normal retirement ages, as follows:

LEOFF II Member Survey	Yes	No	Not Sure
Are you willing to pay an additional:			
2.1% for Age 53 retirement?	63%	12%	25%
3.5% for Age 50 retirement?	50%	15%	35%
PERS II Member Survey			
Are you willing to pay an additional:			
2.0% for age 60 retirement?	69%	11%	20%
3.0% for Age 55 retirement?	50%	28%	22%
TRS II Member Survey			
Are you willing to pay an additional:			
2.4% for Age 60 retirement?	68%	12%	20%
3.75% for Age 55 retirement?	56%	17%	27%

Additional Analysis

How would Approach 1(A) respond to the Evaluation Criteria?

The retirement eligibility criteria in Approach 1(A) reflect a "career retirement" design. Members would become eligible for a lifelong pension at an age when they might be inclined to leave their initial occupation, but before they would plan to permanently leave the workforce. It is likely that this approach would begin to meet the expectations of most employees in the traditional career retirement systems (LEOFF and TRS) as well as most PERS members.

Most LEOFF I members "retire" due to "occupational disabilities" well before they reach age 50. *Therefore it is not likely that lowering the normal retirement age from 58 to 50 would be sufficient to meet the goal of providing a lifelong pension when most LEOFF II members are no longer able to carry out their current occupational duties.* It is predictable, based on experience in other states, that employees would seek further future reductions in the LEOFF II retirement age.

In addition, it is likely that the erosion in purchasing power retirees would experience over more than 30 years of retirement, even with the current Plan II COLA, would lead to pressure for a more generous COLA provision. The cost of post-retirement medical insurance will be a major financial burden for retirees between age 50 and 65. It is also predictable, based on the experience in other states, that retirees will expect the state to subsidize these expenses, based on a "social contract" theory of their benefits.

The following graph shows how the purchasing power of Plan II benefit would be affected by varying levels of post-retirement inflation. If inflation averages 3% per year, the benefit would retain 100% of its initial purchasing power. If inflation averages 5% per year, the benefit would have only 56% of its original purchasing power after 30 years; at 7% per year inflation, only 32% of the purchasing power would remain after 30 years.

Figure 12-4

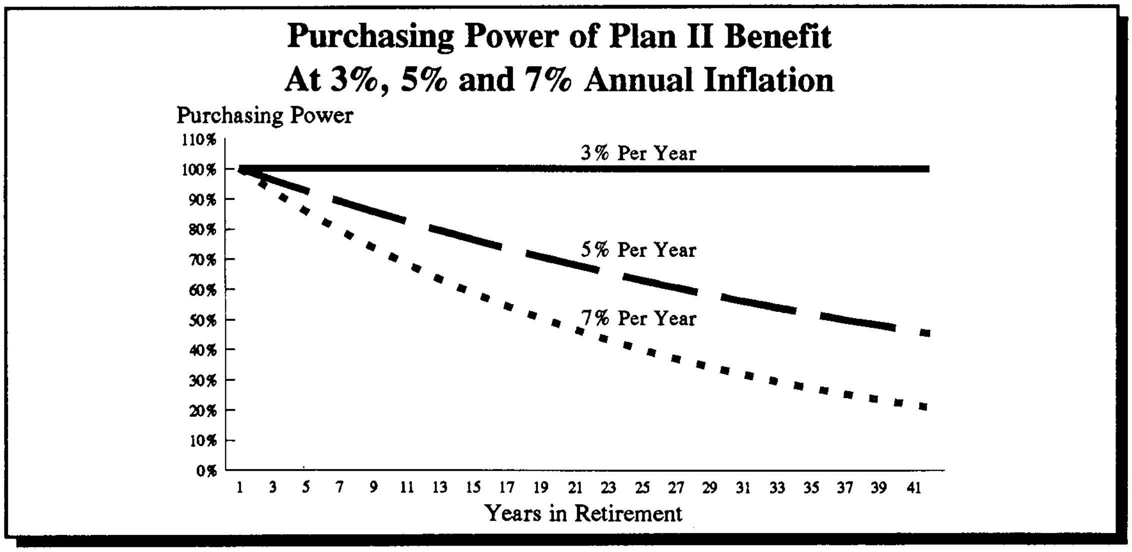
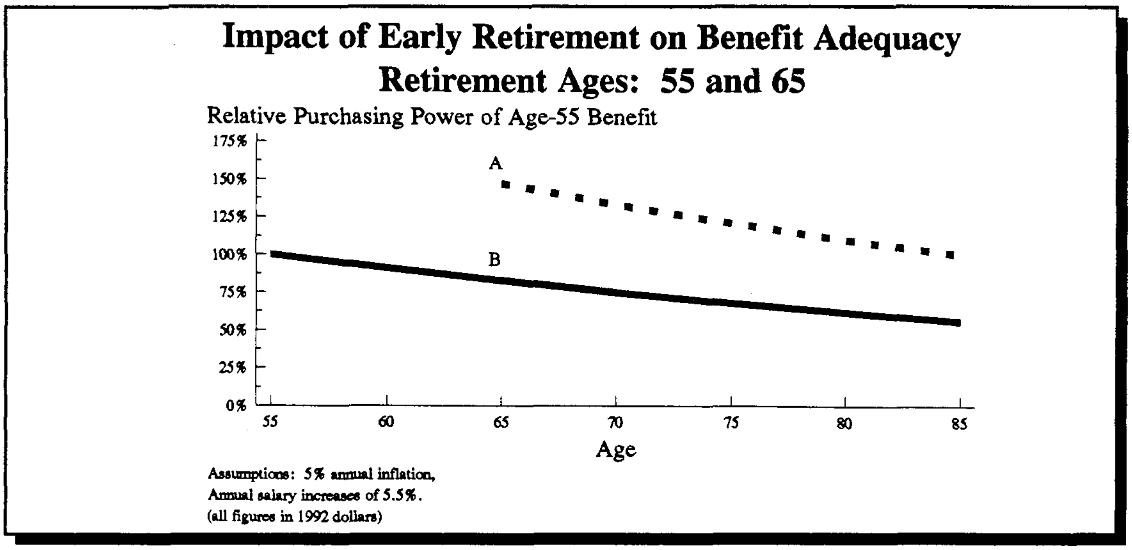


Figure 12-5 shows how the loss of purchasing power is especially a problem for early retirees. The lower solid line shows the decline in purchasing power experienced by a member who retired at age 55 with a benefit based on 25 years service. By age 75, after 20 years of 3% annual COLAs and 7% annual inflation, the initial retirement benefit retains only 47% of its initial purchasing power.

By contrast, the upper-most dashed line shows the relative purchasing power for the same member if he or she stayed in the workforce until retiring at age 65 with 35 years service. In total, the benefit derived from working 10 more years to age 65 (point A on the graph) would result in a benefit that is 177% of the benefit at age 65 for the age 55 retirement (point B on the graph). At age 75 the retiree has a significantly larger benefit, and under identical inflation rates still retains 83% of its initial purchasing power.

Figure 12-5



Likewise, it can also be anticipated that the Plan I retirement eligibility provisions would not completely meet the expectations of the employee organizations representing PERS II and TRS II members. In past years several organizations have proposed earlier retirement for teachers and for various PERS I members. These additional reductions in the Plan I normal retirement provisions have usually been promoted on the theory that employees in certain occupations should not be expected to deal with the stress or physical demands of their jobs for even the 25 or 30 years required for retirement eligibility in PERS I and TRS I.

Approach 1(A) would not respond to most other employee concerns. Members who leave the system prior to retirement would continue to receive little or no value from the retirement systems; no change would be made to the interest rate paid on member contributions; and benefits would continue to be paid only in the form of a lifetime monthly pension.

Approach 1(A) would impact employers much like the current Plan I systems. Retirement contribution rates would be higher. The systems would do little to recruit or retain relatively young or short-serviced employees, but would have a growing "golden handcuffs" affect as employees came closer to normal retirement ages. Productive and unproductive employees alike would be very reluctant to leave covered employment as they got closer to being eligible for a retirement allowance. It would do nothing to promote career transitions for employees prior to normal retirement, and in fact would discourage such changes prior to the normal retirement age.

Upon becoming eligible for retirement, employees would have a tremendous financial incentive to "retire," especially if they had job skills or experience that would be valuable in the private sector or with the federal government, or other non-covered public employers.

Consistency with Plan II Policies

Approach 1(A) would retain most of the benefit design features of the current Plan II systems and would therefore continue most of the policies of the current systems. There would be two major departures from the current policies:

- Retirement benefits would no longer be paid only at an age when employees are generally presumed to permanently leave the workforce; and

- Retirees may not receive an adequate initial benefit (due to less service) and the purchasing power of the initial benefits would not be as well protected for the longer retirement period.

13 Approach 1(B)

Significantly Reduce the Reduction Factors for Calculating Early Retirement Benefits.

Description

Approach 1(B) would keep the current Plan II normal retirement ages, but lower the early retirement adjustment factors from a full actuarial adjustment (about 7 -9 % per year) to 1% per year.

The eligibility criteria for early retirement would remain the same - age 55 with 20 years service in PERS II and TRS II, and age 50 with 20 years service in LEOFF II.

Purpose

This approach would allow eligible PERS II and TRS II members to retire up to 10 years prior to the "normal" retirement age (8 years prior for LEOFF II) without a significant reduction in benefits.

Advantages

(1) Provides greater value for employees who leave employment prior to normal retirement age if they leave after earning 20 years of service and reaching age 55 (PERS II and TRS II), or age 50 (LEOFF II).

(2) The reduction factor for early retirement would not appear to be punitive.

Disadvantages

(1) Does not provide value for employees who leave employment prior to becoming eligible for early retirement.

(2) High cost.

(3) Would lead to additional pressure for COLAs and post-retirement medical insurance.

Costs

Figure 13-1

Subsidize Early Retirement Factors
1% for 10 years (8 LEOFF)

(In Millions)

	PERS	TRS	LEOFF	TOTAL
State & K-12 Biennial Cost 1993-95	$101	$66	$6	$173
Increase in State Rate	2.01%	2.78%	.74%	
Local Government Cost 1993-95*	$51	---	$9	$60
Increase in Local Employer Rate	2.01%	---	1.12%	
Average Increase in Annual Member Cost 1993 (dollars)	$583	$945	$800	
Increase in Member Rate	2.01%	2.78%	1.86%	

* If the State's share of the increased cost in LEOFF II were paid by the local employers, their total rate increase would be 1.86% and the total cost increase would be $15 million for 1993-95.

Possible Variations

Reduce the early retirement reduction factor to match Social Security (5% per year for the first two years; about 6.7% per year thereafter), or to 5% per year. (See Appendix L)

This variation would provide a significant subsidy for persons who wish to retire early. However, since the subsidy would be smaller than the 1% previously discussed, there would still be a significant motivation for delaying retirement.

Another variation on this approach would be to alter the eligibility criteria for early retirement. For example, early retirement could be allowed with fewer years of service.

Figure 13-2

Subsidize Early Retirement Factors
5% for 10 years (8 LEOFF)

(In Millions)

	PERS	TRS	LEOFF	TOTAL
State & K-12 Biennial Cost 1993-95	$34	$23	<$1	$57
Increase in State Rate	.67%	.98%	.04%	
Local Government Cost 1993-95*	$17	---	<$1	$17
Increase in Local Employer Rate	.67%	---	.06%	
Average Increase in Annual Member Cost 1993 (dollars)	$194	$332	$42	
Increase in Member Rate	.67%	.98%	.10%	

* If the State's share of the increased cost in LEOFF II were paid by the local employers, their total rate increase would be .1% and the total cost increase would be $1 million for 1993-95.

Additional Analysis

On its face, Approach 1(B) does not provide for earlier normal retirement. However, adoption of a 1% early reduction factor would be virtually the equivalent of allowing retirement without penalty for those members who meet the early retirement requirements. Figure 13-3 compares how the reduction factors would impact two retirees.

Figure 13-3

Example of Impact of 1% Early Reduction Factor (ERF)

LEOFF II at age 50:	TRS II at age 55:
Age 58 - 50 = 8 yrs = **8% reduction**	Age 65 - 55 = 10 yrs = **10% reduction**
$40,000 x 25 years x 2% = $20,000	$40,000 x 30 years x 2% = $24,000
x .92	x .90
Annual Benefit = $18,400	Annual Benefit = $21,600

Impact of Current ERF

LEOFF II at age 50:	TRS II at age 55:
Age 58 - 50 = 8 years = **55% reduction**	Age 65 - 55 = 10 years = **63% reduction**
$40,000 x 25 years x 2% = $20,000	$40,000 x 30 years x 2% = $24,000
x .45	x .37
Annual Benefit = $9,000	Annual Benefit = $8,880

While such a change might not have the same psychological impact as lowering the normal retirement age, it would provide a very large subsidy (and incentive) for early retirement and would have the practical effect of dramatically reducing the age at which employees could be expected to "retire." It would provide great flexibility for eligible employees to "retire" at early ages if they could not, or did not want to, continue in their current job due to stress, burnout, physical limitations, or for any other reason the employee thought relevant.

Approach 1(B) would not generally respond to employee concerns regarding the lack of "reasonable value" for members who leave prior to retirement; the lack of "market rate" interest on member contributions; nor the lack of flexibility in the form and/or timing of benefits. It would, however, provide employees with "reasonable value" if they left Plan II coverage *after* qualifying for the early retirement option. Also, the early retirement benefits would certainly no longer appear to be punitive. However the Plan II benefits would still not be very flexible; they would still not be available at all prior to the normal retirement age for those with less than 20 years service, and would still only be paid out in the form of an annuity for life.

Approach 1(B) would indirectly, but very significantly, provide employees with the ability to enjoy longer periods of time in retirement.

Approach 1(B) would have an impact on employers very similar to Approach 1(A), except that the "golden handcuffs" effect would apply until the member qualified for the reduced early retirement benefit, rather than until the normal retirement age. It is unlikely that the 1% reduction would deter employees from retiring as soon as they found other employment opportunities. It would not help employees make job transitions before age 50 in LEOFF II or before age 55 in TRS II and PERS II.

Consistency with Plan II Policies

Approach 1(B) would be similar to Approach 1(A) in terms of its consistency with the current Plan II policies. It would retain most of the benefit design features of the current Plan II systems and would therefore continue most of the policies of the current systems. Approach 1(B) would also make the same two policy changes made by Approach 1(A): retirement benefits would be paid prior to when employees were expected to permanently leave the workforce; and it would be less certain that the retirement benefit would be adequate to maintain the retiree's standard of living throughout the period of retirement.

14 Approach 2

Maintain Current Plan II Benefit Design, with Changes to Increase Career Mobility and to Allow Limited Payments Prior to Normal Retirement.

Description

Under this approach two sets of changes would be made to the current Plan II benefits. Three changes would be made to provide greater value to employees who make career transitions prior to retirement:

(1) Provide an automatic annual increase to the vested benefits of members who leave covered service after 20 or more years of service.
(2) Expand the coverage of the current portability statutes to include LEOFF and the cities of Seattle, Tacoma, and Spokane.
(3) Pay "market rate" interest on member contributions.

Three changes would also be made to provide additional flexibility in the form and timing of Plan II benefits. These changes would allow members to be paid their accumulated contributions prior to normal retirement age, or at retirement, in exchange for a reduced permanent retirement allowance:

(1) A job transition/retirement transition benefit.
(2) A phased retirement benefit.
(3) The option to withdraw all or part of the member's contributions at retirement.

1) Automatic Increase for Vested Benefits

Description

Upon separation from covered employment with 20 or more years of service, Plan II members who leave their contributions with the system (also known as terminated, vested members) would have their benefit increased each year during the period between termination and retirement. The annual increase would be based on the same formula as the Plan II COLA - the change in the Seattle CPI, up to 3% per year. The member would not begin receiving the benefit until the normal retirement age (58 or 65).

Purpose

This benefit would help ensure that long-service employees who leave covered positions receive a benefit at the normal retirement age that has increased to keep up with inflation. It would reduce the financial penalty incurred by employees who move to positions in the private sector, or other positions not covered by the state's portability statutes.

Figure 14-1

Example: Automatic Increase for Vested Benefits

	Age 65 Benefit Current	Age 65 Benefit Proposed
Employee with 20 years of service leaves service at age 45 with a $40,000 AFC	$16,000	$28,900

Cost

Figure 14-2

Automatic Increase for Vested Benefits

(In Millions)

	PERS	TRS	LEOFF	TOTAL
State & K-12 Biennial Cost 1993-95	$1	$2	<$1	$3
Increase in State Rate	.03%	.07%	.02%	
Local Government Cost 1993-95*	$1	---	<$1	$1
Increase in Local Employer Rate	.03%	---	.02%	
Average Increase in Annual Member Cost 1993 (dollars)	$8	$23	$16	
Increase in Member Rate	.03%	.07%	.04%	

* If the State's share of the increased cost in LEOFF II were paid by the local employers, their total rate increase would be .04% and the total cost increase would be $1 million for 1993-95.

Advantages

Would make it possible for long-service employees to change jobs to the private or public sector without destroying the value of their retirement benefits.

Disadvantages

Cost.

2) Expand Coverage of Current Portability Statute

Description

The coverage of Chapter 41.54 RCW which creates a portability benefit for members of PERS I, PERS II, TRS I, TRS II, and the WSPRS would be amended to include LEOFF II, and the Seattle, Tacoma, and Spokane employee retirement systems.

Purpose

Expansion of the current portability statutes would remove a current barrier to career transitions between jobs covered by LEOFF II and the Seattle, Tacoma or Spokane systems and jobs covered by PERS, TRS and the WSPRS.

Cost

Figure 14-3

Expanded Portability

(In Millions)

	PERS	**TRS**	**LEOFF**	**TOTAL**
State & K-12 Biennial Cost 1993-95	$1	<$1	<$1	$2
Increase in State Rate (Plan II)	.02%	.01%	.03%	
Local Government Cost 1993-95*	<$1	---	<$1	$1
Increase in Local Employer Rate	.02%	---	.04%	
Average Increase in Annual Member Cost 1993 (dollars)	$6	$3	$30	
Increase in Member Rate (Plan II)	.02%	.01%	.07%	

* If the State's share of the increased cost in LEOFF II were paid by the local employers, their total rate increase would be .07% and the total cost increase would be $1 million for 1993-95.

Advantages

Would make it possible for employees to change jobs to a wider range of public sector positions while maintaining value for their early years of service.

Disadvantages

Cost.

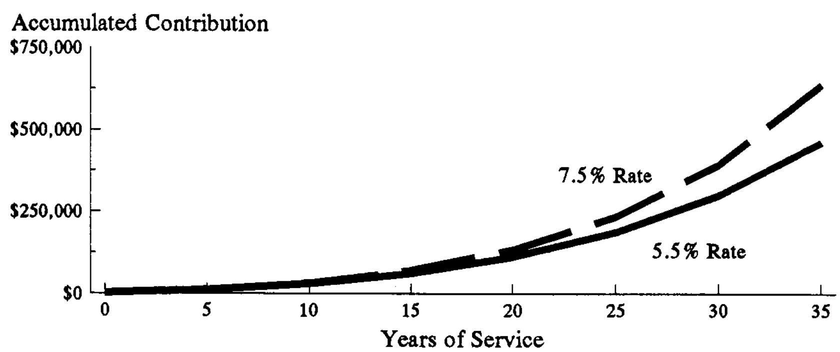
3) <u>Pay "Market Rate" Interest on Member Contributions.</u>

Description

Member contributions would be credited with interest at a rate which more closely reflects market rate interest. This could be accomplished any of a variety of methods, such as by crediting accounts with the average return earned by medium or long-term government bonds, or the five year average returns earned by the State Investment Board.

Figure 14-4

Teachers' Retirement System Plan II
Accumulated Contribution



Assumptions: Begins at $20,000 salary with merit increases plus annual increases of 5.5%. Employee contribution rate of 6.26%.

Purpose

The main purpose of this change would be to increase the *perceived* value of the retirement systems for younger employees. It would also have the indirect impact of increasing the amount of benefits employees might be able to collect early under the job transition benefit and the amount the member could withdraw at retirement.

Advantages

(1) Would increase the *perceived* value for the retirement systems for *active* employees.
(2) Responds to the most frequent active-member complaint.

Disadvantages

Cost.

Cost

Figure 14-5

"Market Rate" Interest (Assume 7.5%)

(In Millions)

	PERS	TRS	LEOFF	TOTAL
State & K-12 Biennial Cost 1993-95	$3	$1	<$1	$4
Increase in State Rate	.06%	.04%	.01%	
Local Government Cost 1993-95*	$1.5	---	<$1	$2
Increase in Local Employer Rate	.06%	---	.01%	
Average Increase in Annual Member Cost 1993 (dollars)	$17	$14	$9	
Increase in Member Rate	.06%	.04%	.02%	

* If the State's share of the increased cost in LEOFF II were paid by the local employers, their total rate increase would be .02% and the total cost increase would be less than $1 million for 1993-95.

Additional Analysis

How would the first three changes respond to the Evaluation Criteria?

The primary impact of these changes would be to increase the value of the accrued retirement benefits earned by long-service employees who leave Plan II coverage prior to retiring.

The automatic increase for vested benefits would promote members' ability to make career changes to jobs in the private sector, to the federal government, or to other states. For example, it would facilitate the ability of LEOFF II members to move to private sector security companies after leaving law enforcement positions.

The portability statute change would provide a means for employees to switch between a wider variety of jobs in state and local government without suffering a significant reduction in the value of the retirement benefits earned in the earlier job. For example, it would allow LEOFF II members to maintain much of the value of their accrued benefit when moving to jobs covered by PERS II, TRS II, WSPRS or by the Seattle, Tacoma, or Spokane city employee retirement systems.

The increase in the interest rate would directly respond to one of the most frequently voiced member concerns about the Plan II systems. It would also indirectly have the impact of providing greater value to employees who leave prior to retirement, and of increasing the flexibility of Plan II benefits if it were combined with the job/retirement transition benefit proposal and the phased retirement proposal.

Employer Concerns

These changes would reduce one of the barriers faced by employees wishing to make job changes prior to normal retirement age. In some cases, this would be an advantage to the employer; in other cases, a disadvantage.

The automatic increase for vested benefits may not provide a strong incentive for employees to leave prior to retirement age but it would permit employees to change jobs without suffering a substantial loss of value in their retirement benefits. This may make it easier for employers to convince unsatisfactory employees to change jobs.

The portability statute change would have a similar impact. It would not provide an incentive for employees to change jobs, but it would greatly reduce or eliminate the financial penalty facing employees who had a desire to make a job change to or from one of the systems added to the chapter's coverage.

To the extent payment of market rate interest was combined with the job transition benefit change, it would have the impact of making more funds available for persons wanting to take advantage of the job transition benefit.

Consistency with Plan II Policies

All these changes would be consistent with the current Plan II policies, and would specifically increase the likelihood that long-service employees would receive adequate initial retirement benefits.

4) Optional Job/Retirement Transition Benefit

Description

A new benefit option would permit Plan II members with 20 or more years of service to be paid a monthly income from their accumulated contributions under two circumstances:

- 50% of pay for up to two years, while training for a new career or on a sabbatical break (job transition benefit); or

- up to 50% of pay, or the member's accrued benefit, when leaving the work force between age 60 and 65 (retirement transition benefit, PERS II and TRS II only).

The member would receive a reduced benefit at retirement to reflect the member contributions paid out before normal retirement age. The reduced benefit could be actuarially equivalent or could be partially subsidized.

Purpose of Benefit

The job transition benefit would provide long-service members with a means to support themselves for up to two years while they get training or additional education for a new career, or take a sabbatical leave. Members would not be required to return to covered employment, although they would have a strong incentive to do so. The benefit would make it easier for employees to plan for career transitions.

The retirement transition benefit would provide long-term employees who wish to leave the workforce prior to being eligible for unreduced retirement benefits and Social Security with a source of income to "bridge" the period between age 60 and when the retiree applies for retirement and Social Security. (LEOFF II members would not be included since they are already eligible for unreduced benefits prior to the Social Security early retirement age.)

Both benefits would, in essence, permit a member to receive payment of all or part of their member contributions prior to retirement, without destroying their eligibility for a benefit provided by the employer.

Figure 14-6

Example of "Job Transition" Benefit (Percentage Reduction in Initial Retirement Benefit at Age 65)

Age and Service at time of Sabbatical/ Job Transition	Sabbatical Leave (Return to Covered Service)	Career Change (No Return to Covered Service)
Age 50, 20 Years of Service	11% Reduction	32% Reduction (from terminated, vested benefit)

Assumptions: (1) Employee starting salary of $20,000, with average merit and general annual increases. (2) Employee collects 50% of salary for 12 months.

Cost

As proposed, those members who receive a job transition or retirement transition benefit would later receive an actuarially reduced allowance at normal retirement. This option would result in no additional cost to the state. If the state wished to partially subsidize the benefit, such as by not providing for a full actuarial reduction at retirement, there would be a cost. Local government could also be authorized to provide this benefit on a "self-pay" basis.

Advantages

Provides additional flexibility to employees in certain limited circumstances.

Disadvantages

(1) Only provides flexibility in certain limited circumstances. Requires employer approval.
(2) Possible federal tax code limitations.
(3) Possible administrative complexity.

5) <u>Optional "Phased Retirement" Benefit</u>

Description

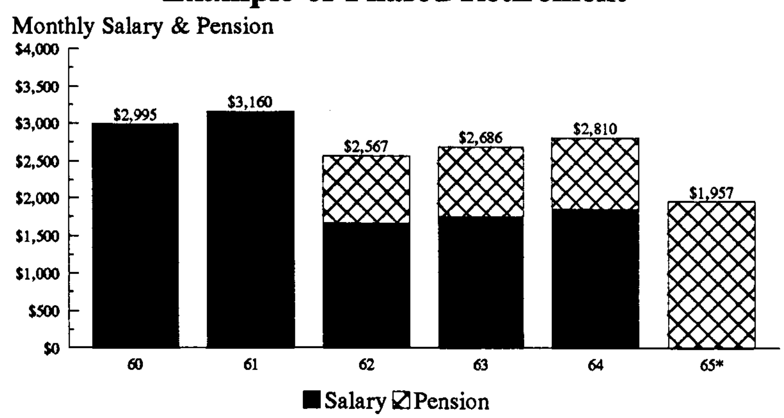
A new benefit option would permit PERS II and TRS II members to work half-time and at the same time collect 50% of their accrued retirement allowance, for up to 3 years prior to full retirement. The members would have to be age 62 or older and would have to enter into a contract for the half-time service with his or her employer. At full retirement, the member's benefit would be calculated using a full-time salary, and partial credit for the period of part-time employment.

Purpose of Benefit

This benefit would provide a limited option for persons who felt they did not want to, or could not, continue in full-time employment until age 65, but could continue in a part-time position.

Figure 14-7

Example of Phased Retirement



* Age 65 benefit is reduced to reflect 3 years of early payouts. Without the the reduction the benefit would be $2,222.
Assumptions: 30 years of service as of age 62. Half-time employment from age 62, collects 50% of accrued benefit for 3 years. Full retirement at age 65.

Cost

The member who takes advantage of the phased retirement option would receive a reduced benefit at normal retirement to adjust for payments made prior to the normal retirement age. If a full actuarial reduction were made, there would be no cost to the system.

Advantages

Provides additional flexibility to employees in certain limited circumstances.

Disadvantages

Only provides flexibility in certain limited circumstances and requires employer approval.

6) <u>Withdrawal of Accumulated Contributions at Retirement</u>

Brief Description

Plan II members would be permitted to withdraw their contributions, plus interest, at retirement, as TRS I members are currently allowed to do. The retiree's retirement allowance would be actuarially reduced to reflect the value of the withdrawn contributions.

Purpose of Benefit

This change would provide Plan II retirees with greater flexibility in shaping their retirement income. Amounts that are withdrawn could be used to purchase annuities that provided a different payment stream than the Plan II allowance. However the primary purpose of making this change would be to provide a benefit that is very popular with members and yet cost neutral to the state.

Cost

The cashout of contributions at retirement option could be implemented on a cost neutral basis.

Advantages

Withdrawal of contributions at retirement is very popular in TRS I.

Disadvantages

Retirees may later regret reduction in their monthly pension.

Additional Analysis

How do the last three changes respond to the Evaluation Criteria?

The job transition benefit would not provide for a lifetime retirement income following completion of a career prior to age 58 (LEOFF II) or 65 (TRS II, PERS II). Instead it would take the approach of providing support for long-service employees who want or need to make career changes, regardless of why the employee wants or needs to make the change. It could also be used to provide support for persons in stressful jobs by giving them the means to take sabbatical breaks, rather than beginning payment of a lifelong retirement pension. Persons starting their first career at age 30 would be able to take sabbatical breaks, or train for a second career, after age 50.

The retirement transition benefit and phased retirement option would both provide PERS II and TRS II members over the age of 60 with additional flexibility in transitioning into retirement. The phased retirement option would provide increased flexibility for persons who were close to the normal retirement age and felt a desire or need to work less than full time. It would allow persons in stressful occupations, such as teaching and social work, to reduce their workload in the years leading to retirement with a smaller impact on their long-term benefits than under current provisions.

Allowing retirees to withdraw their contributions would not affect retirement eligibility in any way, but would provide retirees with greater flexibility in the form of their benefit payment. This provision has been very popular with TRS I retirees; over 80% of those who retired in 1990 elected to withdraw all or part of their contributions.

Employer Concerns

The transition benefit would presumably make it somewhat more difficult to retain employees, and somewhat easier to motivate unproductive employees to make job changes. These impacts would be increased, perhaps significantly, if the other changes included in Approach 2 were also adopted.

The phased retirement benefit would only impact employees who were age 62 or older. Within this group it would provide a means to give employees a break from the stress of full-time employment a few years earlier.

Consistency with Plan II Policies

The retirement transition benefit would be similar in nature to the current early retirement option in the Plan II systems. However, the job transition benefit would involve a change in current policy in that it would be paid prior to an age when employees were expected to permanently leave the workforce.

The phased retirement benefit would be consistent with current Plan II policies; in effect, it would provide a degree of flexibility in defining the age at which employees are presumed to leave the workforce permanently.

The cashout of contributions at retirement option would conflict, at least in part, with the Plan II policy that retirees' benefits should be secure, not dependent on the judgment of the retiree. Providing retirees with increased flexibility in the form of their benefit payments would necessarily increase the risk that some would make decisions that resulted in them having inadequate retirement income later in their retirement.

15 Approach 3

Allow Employees to Choose Between Three Different Retirement Plans, Each with Benefits Similar to Current Plan II Systems, Except for Different Normal Retirement Ages.

Description

Create three new retirement plans with benefit provisions similar to PERS II, except that each retirement plan would have a different normal retirement age: age 65 (Tier 3A), age 60 (Tier 3B), and age 55 (Tier 3C).

Employees would have the option of selecting which plan they wished to be covered under, but would pay higher contribution rates for service earned under the plans with the earlier retirement ages (Tiers 3B and 3C). Benefits would be portable, i.e., the salary earned while participating in one of the three plans could be used to calculate benefits in the other two plans. Employees would be given frequent chances to move between the different plans.

Purpose

Make it possible for employees who want to retire at earlier ages to qualify for earlier retirement by paying a higher contribution rate, while also allowing those who are content to work until age 65 the option of being covered in a plan with a lower contribution rate.

Advantages

Provides employees with a choice of retirement ages; only those who value earlier retirement have to pay higher contribution rates.

Disadvantages

(1) Does not provide value for employees who leave prior to retirement.
(2) Cost to the state would be dictated by employee choices: could be high cost if most employees choose the age 55 and 60 plans.
(3) Employees who choose the age 55 plan are likely to bring pressure for improved COLAs and post-retirement medical benefits.
(4) Does not provide flexibility for employees who select the age 65 plan, but at a late age decide they want or need to leave the workforce prior to age 65.

Cost

Assuming the equal contribution sharing policy of the Plan II systems is retained, this approach could require significant increases in employer contribution rates, depending on which employees and how many employees selected the age 55 and 60 plans. Substantial additional analysis would be necessary to develop a reliable cost estimate.

If employee contribution rates were increased to pay 100% of the additional cost associated with the lower retirement age options, there would be no additional cost to the state. Relatively few employees would be expected to select the earlier retirement plans.

Additional Analysis

How would Approach 3 respond to the Evaluation Criteria?

This approach would partially respond to the desire of employees to be able to retire when they can no longer carry out the duties of their current career. It would allow employees to decide in advance how long they wanted to work, and to "purchase" an earlier retirement (i.e., age 55 or 60) by making higher employee contributions. The age 55 and 60 options might meet the expectations of most teachers and general public employees. However, most LEOFF employees leave their public safety positions well prior to age 55, as evidenced by the fact that the average "retirement" age for LEOFF I members is age 48.

Another likely problem with this approach is that persons are not always able to predict how long they will want to work in a career. Employees might sign up for the age 65 plan while young, to minimize their deductions, and later find that they want to leave their career job at an earlier age.

This approach would not provide better value for employees who leave prior to retirement. It would provide a little more flexibility regarding how early employees could begin to collect their retirement benefits. It would likely be popular with employees as a "defined benefit" counterpart to the 401(k) plans provided in the private sector.

Employees could, in effect, obtain 100% matching employer contributions for their higher employee contributions.

Employer Concerns

The personnel impact of this approach would be similar to the current situation under the plan I systems, as discussed in Approach 1(A).

Consistency with Plan II Policies

Like Approach 1(A), this approach would retain most of the benefit design features of the current Plan II systems and would therefore continue most of the policies of the current systems. There would be two major departures from the current policies:

- Retirement benefits would no longer be paid only at an age when employees are generally presumed to permanently leave the workforce; and

- Retirees who elected the age 55 plan may not receive an adequate initial benefit (due to less service) and the purchasing power of the initial benefit would not be as well protected for the longer retirement period.

16 Approach 4

Replace Current Plan II Systems/Benefits with New "Split Plans" Which Reflect Typical Private Sector and New Federal Employees Retirement System (FERS) Plan Design.

Description

Create a new retirement system which includes both an employer-paid basic defined benefit pension and an employer- and employee-funded defined contribution account.

Employer-funded basic defined benefit plan:

Under this approach the employer would provide a "basic" retirement pension which would provide a basic level of financial security when combined with Social Security benefits. The normal retirement age for the basic pension would remain the same as the current Plan II systems. Most other provisions of the basic pension would also be identical to current Plan II provisions, except:

(1) The benefit would be paid totally by the employer;
(2) The benefit would be based on a 1% formula;
(3) The benefit would "vest" after 10 years; and
(4) Terminated, vested benefits would receive annual increases such as discussed in Approach 2.

Employee- and employer-funded defined contribution plan:

This approach would also include a mandatory defined contribution plan. Employees would contribute 6% of compensation to a defined contribution plan, a level roughly equal to an average of the current Plan II employee contribution rates. All employers would contribute an additional 1% of compensation, which, when combined with the cost of the employer-paid basic pension, would be only a little more expensive than the current state cost for the Plan II systems.

In addition, local employers would be permitted to contribute an additional amount for LEOFF employees to pre-fund "retirement bridge" benefits.

The benefits would be payable upon the same conditions, and in the same forms, discussed in Approach 5.

Purpose

This design would provide a balance between the policy goals promoted by defined benefit plans and those promoted by defined contribution plans. The defined contribution part of the plan would provide greater value for employees who change jobs prior to retirement, and provide greater flexibility in the timing and form of benefits. The basic pension would continue to fulfill many of the policy goals implicit in the current Plan II systems.

Figure 16-1

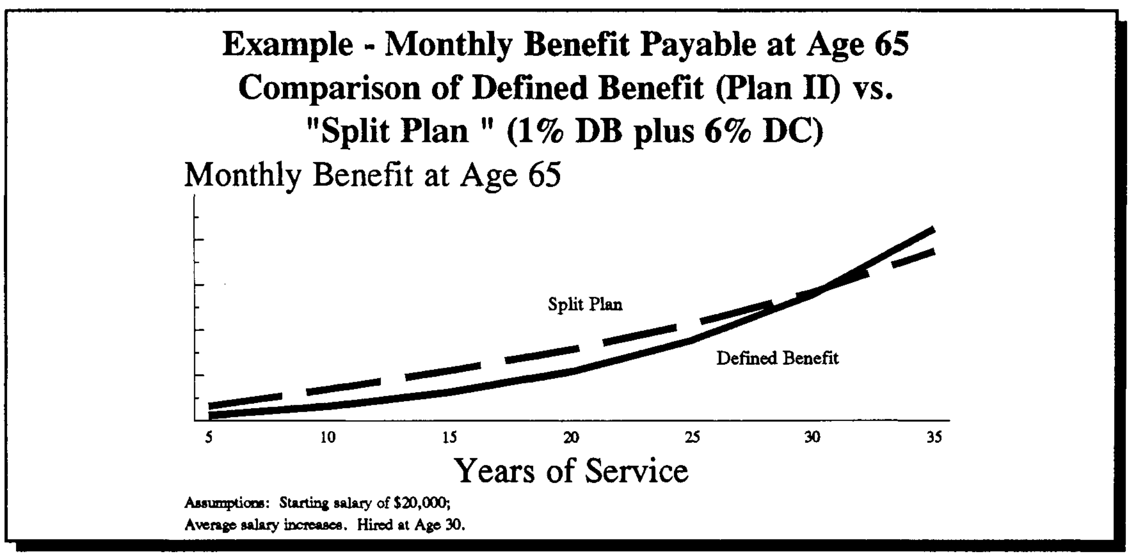
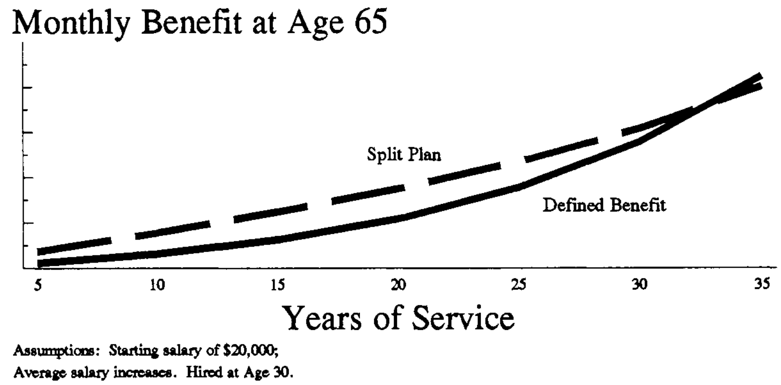


Figure 16-2

Example - Monthly Benefit Payable at Age 65
Comparison of Defined Benefit (Plan II) vs.
"Split Plan " (1% DB plus 7% DC)



Advantages

(1) Provides increased value for employees who change jobs before retirement.
(2) Provides increased flexibility in the timing and structure of payments from the defined contribution plan.
(3) Reflects the retirement benefit design most widely used by larger private sector companies and the new Federal Employees Retirement System.

Disadvantages

(1) Retirees take on investment risk for the defined contribution part of their benefits.
(2) For a given level of funding, benefits generally will not be as generous for those who work until retirement because more value is provided to employees who leave prior to retirement.

Cost

This approach would probably involve a small increase in employer pension costs (less than 1% of pay). The difference between the cost of providing the new defined benefit plans and the current employer cost for the Plan II systems could be defined as the amount committed as the employer contribution to the defined contribution account.

This approach could be made more or less expensive by altering the defined benefit design, or by changing the level of employer contributions to the defined contribution account.

Additional Analysis

How would Approach 4 respond to the Evaluation Criteria?

The split plan option would probably not meet the expectations of public safety employees and teachers that they "deserve" early retirement because of the nature of the service they perform. The employer-provided pension would be paid at the current Plan II retirement ages (58 or 65), i.e., when the employees were presumed to be leaving the workforce (or earlier, in the case of LEOFF II), not necessarily when they separate from their initial careers.

However, the defined contribution plan could partially respond to the desires of those employees who want to be able to collect a retirement income when they leave their initial careers. It could allow such employees to withdraw all or part of their account to use as a source of "bridge income" prior to normal retirement age. (This would be similar to the retirement transition benefit proposed in Approach 2.) One of the advantages of the defined contribution design is that employees could individually balance their desire to "retire" early (due to stress, burnout, physical problems, or whatever reason) against their desire for the larger retirement income that would result from additional years of contributions and a shorter annuity payout period.

LEOFF II employers would also be permitted to make additional contributions to help pre-fund a "bridge income" benefit. Such a benefit could provide an additional source of income between the time a member leaves public safety work and when they qualify for their basic pension at age 58.

The defined contribution plan, with market rate interest, would provide employees who change jobs prior to retirement with more value (i.e., more "portability") for that part of their benefit.

The inclusion of the vested terminated benefit COLA would increase the value of the defined benefit plan to members who left with 20 years of service. However, the vesting period would be changed from the current 5-year period to a 10-year period in order to avoid the administrative costs associated with record keeping and the payment of numerous small benefits.

Employees could be given greater flexibility in structuring the timing and form of their defined contribution account payout. They could be allowed to withdraw all their contributions at retirement, or collect their payments as an annuity for life, or any one of a number of other options. One of the primary advantages of defined contribution plans is their flexibility.

However, employees would have no flexibility regarding the payout of their employer funded basic pension. Since it would be intended to provide a basic level of financial security in retirement it would retain a "paternalistic" design.

The defined contribution plan would provide flexibility for employees who wished to begin retirement earlier and who were willing to accept a lower long-term level of retirement income, or who had access to other sources of retirement income (i.e., 457 or 403(b) plans). The defined benefit plan would not provide a longer period of paid retirement.

Employer Concerns

A split plan would probably have the impact of helping retain some employees (those who wanted to qualify for the vested, terminated benefit COLA); however, it would also make it easier for employees to leave since it would provide a defined contribution plan as a significant part of the total benefit.

The defined contribution plan would provide much flexibility to accomplish the goals of reducing barriers and providing support for employees who want to take sabbatical breaks and/or want to train for new careers. The terminated vested benefit COLA on the defined benefit plan would also be of help for long-service employees.

Consistency with Plan II policies

Approach 4 would involve a major change in the design of the state's retirement benefits from the current Plan II systems. Not surprisingly it would also involve some major changes to the state's current retirement benefit policies.

A major policy change implicit with Approach 4 is that only the employer-provided defined benefit would be guaranteed as to amount; the benefit generated by the defined contribution account would vary depending on investment return prior to retirement. For this reason it would not be guaranteed that a career employee would always end up with a specific level of retirement income.

The purchasing power of the basic benefit provided by the employer would be maintained. The member would also be able to elect a variable annuity payout option that would also maintain some degree of purchasing power for the benefit paid from the defined contribution account, but the member would not be required to select such an option, and few probably would.

The employer-provided benefit would be secure - almost identical to the current Plan II benefit, except for its level. The defined contribution plan benefit would NOT be secure: poor investment returns and/or retiree decisions could reduce the level of benefit received by a retiree later in life.

In theory, the contribution rates for employees and employers would not be affected by the change in plan design. However, the dynamic would be different since the contribution/cost of the defined benefit plan would vary over time while the employee contribution to the defined contribution plan would remain the same.

Similar or equal benefits would continue to be provided to all employees, except for a continuation of the current retirement age difference for LEOFF II, and the provision allowing LEOFF II employers to contribute an additional amount to the defined contribution plans to fund a "retirement bridge" benefit.

17 Approach 5

Replace Plan II Systems with Defined Contribution Plan

Description

Replace the Plan II systems with a defined contribution retirement plan closely modeled after the TIAA-CREF plan for higher education faculty, but with contribution rates that reflect the average current Plan II rates. (Approximately 6% from both employees and employers.) Contributions would vest immediately to the member and would earn market rate interest. Benefits could be made payable upon separation from service, disability, or death.

Benefits could be made payable in the form of a regular or variable monthly allowance (annuity) for life, such as in TIAA-CREF. If there was a desire to provide more flexibility, the benefit could also be paid in a variety of other forms such as an annuity for a fixed period, a rollover to an IRA, or as a lump sum payment. Spousal consent could be required for payments that do not include a survivor benefit.

Purpose

Such a plan design would provide a source of retirement savings which would be highly portable for employees who switch jobs prior to normal retirement age.

Advantages

(1) Employees who change careers prior to retirement receive full value for their early periods of service.
(2) Employees have greater flexibility in deciding when to retire, and in structuring the payout of their retirement benefits.
(3) Employees are more likely to appreciate the value of their retirement benefits.

Disadvantages

(1) Employees would take on the risk of poor investment returns. If investment

experience is poor, retirees may complain that employees who provided identical period of service receive different retirement benefits.

(2) If retirees are provided flexibility in their payout options, they could outlive their retirement savings.

(3) For a given level of funding, those who stay until retirement will, on average, receive smaller benefits than under the Plan II defined benefit design.

Figure 17-1

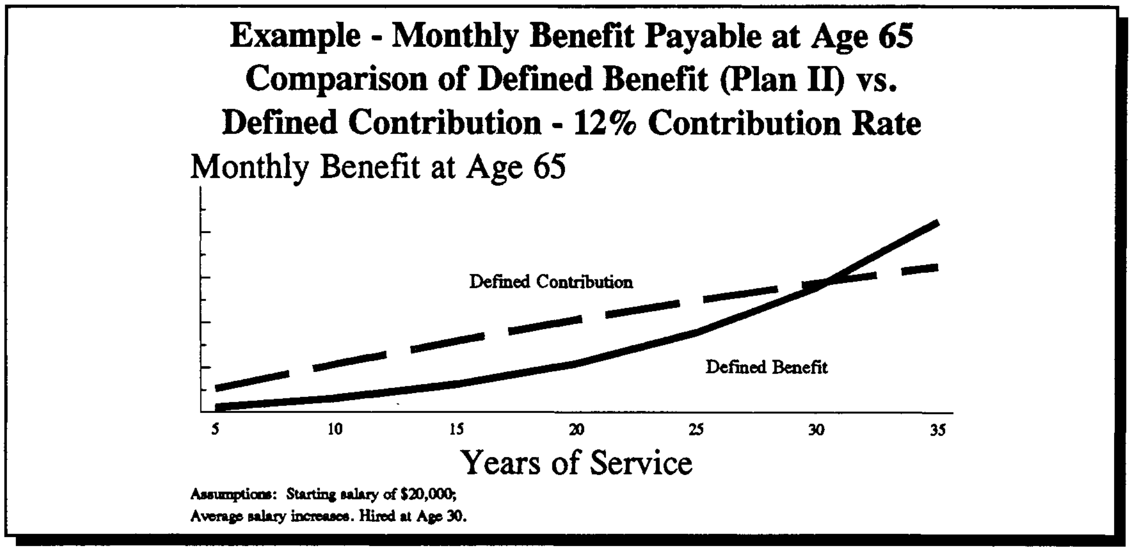
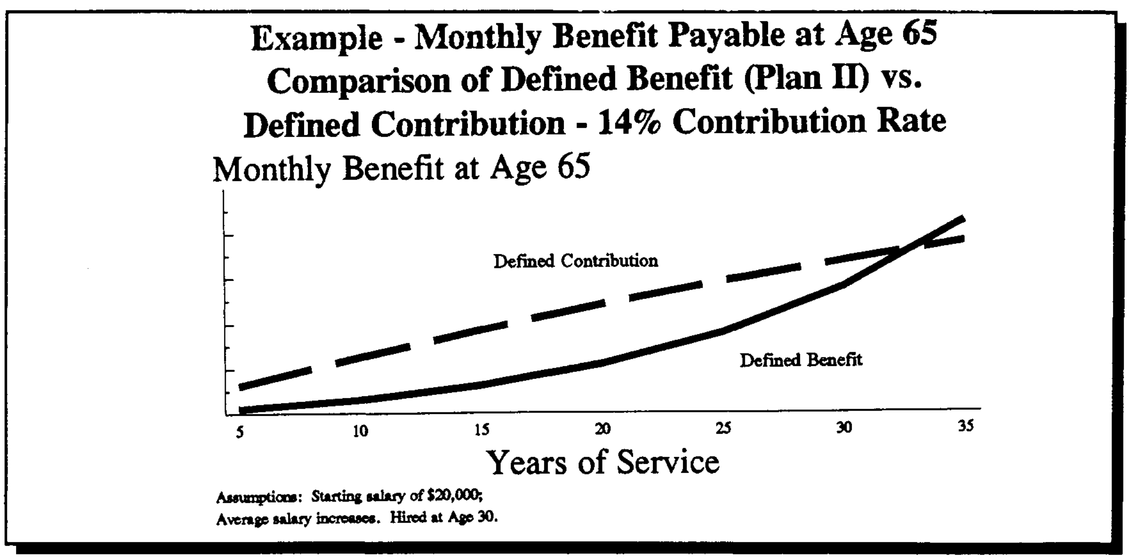


Figure 17-2



Cost

A defined contribution plan could be implemented with whatever levels of employer and employee contributions were desired. The current Plan II contribution rates are:

	PERS II	TRS II	LEOFF II
Employee	4.85%	6.26%	7.01%
Employer	4.85%	6.26%	4.21%
State	---	---	2.80%

Under the proposal, identical employer and employee contribution rates would be used for all Plan II members.

The employee/employer rates could each be set permanently at 6%, about the average of the three systems.

Rates would be stable and predictable, as compared to the Plan II defined benefit plans.

Additional Analysis

How would Approach 5 respond to the Evaluation Criteria?

This approach does not specifically provide a lifelong benefit upon completion of a certain number of years of service. However, a defined contribution plan can provide employees with access to a source of retirement income if they wish to, or need to, separate from employment for any reason. (Benefits paid before age 55 might be subject to an additional 10% federal income tax.) If there were a desire to make it easier for certain groups of employees to leave at earlier ages, the plan could provide for higher contribution rates for those groups of employees.

The benefit would be 100% "portable"; employees would maintain the full value of their accrued retirement benefits regardless of what job changes they made.

Employees would receive market rate interest on their savings. However the state would be in a perpetual tension between being asked to give employees more control over their investments and protecting employees from the impact of poor investment experience.

Defined contribution plans can provide great flexibility in the form/timing of benefit payments by offering a variety of payment options. The nature of defined contribution accounts is that they do not have to involve eligibility "cliffs". They can permit early retirement while still providing a significant economic incentive to delay retirement.

Employer Concerns

Defined contribution plans are more popular with younger and/or mobile employees. While retirement benefits are not usually a significant factor in recruiting employees, younger employees are likely to perceive a defined contribution plan as a more valuable benefit than a defined benefit plan.

The "golden handcuff" nature of the Plan II design would be almost totally eliminated. Employees with long service would have less incentive to stay in their current positions prior to becoming eligible for retirement. However, they would have much more incentive to stay after becoming eligible for retirement.

A defined contribution plan would also make it easier for employees to make career changes. The benefits would be highly "portable" and therefore would not act as a deterrent to job changes. In addition, it is possible that employees could draw upon their accumulated contributions, subject to possible federal tax restrictions, to provide income for training or sabbatical periods.

Consistency with Plan II policies

The most important change would be that the adequacy of the benefit in retirement would depend on the investment return received on the defined contribution plan funds. The risk of poor returns would be shifted from the employers/state to the employee; likewise the benefits of better than expected returns would be shifted from the employers/state to the employees.

Retirees would be able to select a "variable annuity" payout form if they wanted protection from inflation. Otherwise the payout options would not necessarily maintain the retiree's purchasing power.

If retirees are permitted to select from a variety of retirement payout options, the plan design would not ensure their long-term financial security. The responsibility for the retiree's long-term financial security would shift entirely to the retiree.